
Advisory Committee on Tax Exempt and Government Entities (ACT)

Report of Recommendations



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**Advisory Committee on Tax Exempt and Government Entities (ACT)
Public Meeting
1111 Constitution Ave., NW
Washington, D.C. 20224**

June 10, 2009

AGENDA

Welcome and Opening Remarks:

- Sarah Hall Ingram, Commissioner, Tax Exempt and Government Entities
- Steven J. Pyrek, Designated Federal Official of the ACT
- Susan D. Diehl, Chair of the ACT

Reports of Recommendations:

Exempt Organizations: Recommendations to Improve the Tax Rules Governing International Grantmaking

International Pension Issues in a Global Economy: A Survey and Assessment of IRS' Role in Breaking Down the Barriers

Record Retention Requirements for Tax-Exempt Bonds and Tax Credit Bonds: A Specific Proposal for Published Guidance

Federal-State-Local Government Compliance Verification Checklist for Public Employers

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**ADVISORY COMMITTEE
ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT)**

2008-2009

Member Biographies

EMPLOYEE PLANS

Susan D. Diehl, Horsham, PA

Ms. Diehl is the president of PenServ Inc., a nationally recognized pension consulting firm providing services to more than 800 financial organizations on sponsoring retirement plans. A major part of her activities and products involves educating individuals and practitioners on the whole range of retirement plans — including IRAs, Qualified Plans, 403(b) and 457 plans, and Nonqualified Deferred Compensation Plans. Ms. Diehl has a Bachelor of Arts in mathematics from Arcadia University in Pennsylvania.

Dodi Walker Gross, Pittsburgh, PA

Ms. Gross is an executive compensation and employee benefits lawyer and partner with Reed Smith LLP, a global relationship law firm with nearly 1,700 lawyers in 23 offices throughout the United States, Europe, Asia and the Middle East. In this capacity, she represents local, national and multinational corporations. Her work encompasses the full range of matters with respect to retirement, savings, welfare and nonqualified deferred compensation plans and related employment matters — including design, administration, compliance, dispute resolution, Qualified Domestic Relations Orders (QDROs), government audits, collective bargaining, reductions in force, and corporate transactions. Ms. Gross has a Juris Doctor from Duquesne University School of Law and is a Fellow of the American College of Employee Benefits Counsel.

G. Daniel Miller, Washington, DC

Mr. Miller is a partner in the Washington, DC, office of Conner & Winters LLP, and a member of that firm's Employee Benefits Practice Group. As a specialist in employee benefits for more than 30 years, he serves the needs of both large and small for-profit employers and the deferred compensation planning needs of a variety of non-profit employers. He is also a member of the Employee Benefits Committee of the Tax Section of the American Bar Association. Mr. Miller received his Juris Doctorate from the Vanderbilt University School of Law.

Susan P. Serota, New York, NY

Ms. Serota is a partner in the New York office of Pillsbury Winthrop Shaw Pittman LLP and chair of the firm's Executive Compensation and Employee Benefits practice. She has broad experience in complicated tax issues and analysis, including defined benefit plans, hybrid plans, section 409A non-qualified deferred compensation arrangements, and section 457 deferred compensation plans for tax-exempt and government entities. In 2006 – 2007, she served as the Chair of the American Bar Association Section of Taxation. Ms. Serota received her Juris Doctorate from the New York University School of Law.

Michael M. Spickard , Akron, OH

Mr. Spickard is the owner, chief executive officer and chief actuary of Summit Retirement Plans Services, a leading third-party administrator in northern Ohio. He has more than 18 years experience designing and administering all types of retirement plans, with in-depth experience in the areas of salaried, hourly and union defined benefit plans. Mr. Spickard holds a Bachelor of Science in Applied Mathematics from the University of Akron.

Marcia S. Wagner, Boston, MA

Ms. Wagner is a principal of The Wagner Law Group, an ERISA/employee benefits boutique law firm. Ms. Wagner specializes in the full range of employee benefits matters with respect to retirement plans, welfare plans and executive compensation. With respect to such plans, she specializes in design, administration, compliance, dispute resolution, government audits, and corporate and employment transactions. Ms. Wagner received her Juris Doctor from Harvard Law School.

EXEMPT ORGANIZATIONS

Bonnie Brier, Philadelphia, PA

Ms. Brier is the general counsel of The Children's Hospital of Philadelphia. She is a past chair of the American Bar Association Health Law Section and of the Exempt Organizations Committee of the American Bar Association Taxation Section. In her over 25 years of practice in the field of exempt organizations, she has specialized in the area of health care, compensation and benefits, charitable giving and nonprofit governance. Ms. Brier has an A.B. from Cornell University and a Juris Doctor from Stanford University.

Fred T. Goldberg Jr., Washington, DC

Mr. Goldberg is a partner at Skadden, Arps, Slate, Meagher & Flom LLP, with a broad gauged tax practice that includes not only exempt organizations but also employee plans and tax exempt bonds. Mr. Goldberg served as Chief Counsel of the Internal Revenue Service (1984 – 1986), Commissioner of Internal Revenue

(1989 – 1991) and Assistant Secretary (Tax Policy) (1992). He holds a Juris Doctor from Yale University.

Karin Kunstler Goldman, New York, NY

Ms. Goldman is Assistant Attorney General in the Charities Bureau of the New York State Department of Law, where she has a wide range of responsibilities in the oversight of tax-exempt entities. Ms. Goldman is responsible for the Bureau's public education program and has also coordinated multi-state enforcement actions. She is a past president of the National Association of State Charities Officials (NASCO), and has been active in conducting educational seminars for officers, employees, and volunteers of exempt organizations throughout the State of New York. Ms. Goldman holds a Juris Doctorate from Rutgers Law School.

Mary Rauschenberg, Chicago, IL

Ms. Rauschenberg is Director of Deloitte Tax LLP's Chicago healthcare and not-for-profit tax practices. Her clients include academic medical centers, colleges and universities, teaching hospitals, cultural organizations, trade associations, public and private foundations, and other tax-exempt organizations. Ms. Rauschenberg holds a Masters of Accounting Science from the University of Illinois.

Jack B. Siegel, Chicago, IL

Mr. Siegel is an attorney (Illinois and Wisconsin) and CPA (Wisconsin) providing consulting services to nonprofits through Charity Governance Consulting LLC. He focuses on board and staff training, governance, financial management, record retention, and special projects. Mr. Siegel is the author of "A Desktop Guide for Nonprofit Directors, Officers, and Advisors: Avoiding Trouble While Doing Good" (Wiley 2006), a 750-page guide addressing the legal, financial, tax, regulatory, and governance issues facing nonprofit boards and senior officers. He also maintains a blog at <http://www.charitygovernance.com>. He currently is completing a book on the role of audit committees and auditors in nonprofit financial governance. Mr. Siegel has an LLM in Taxation from New York University and a Masters of Management from Northwestern University.

Ana Thompson, Palo Alto, CA

Ms. Thompson is the executive director of the Charles and Helen Schwab Foundation, where she works closely with the Board of Directors to identify and select nonprofit organizations that demonstrate an entrepreneurial and results oriented approach to the services they provide. In recent years, the Foundation has supported organizations working in the areas of K-12 education reform, homelessness, poverty prevention, fine arts, health and learning difficulties. Ms. Thompson has a Masters of Business Administration from the Stanford Graduate School of Business.

GOVERNMENT ENTITIES: FEDERAL, STATE AND LOCAL GOVERNMENTS

Steven W. Hoffman, Columbus, OH

Mr. Hoffman is Director, Tax Services, Payroll and Employee Data Services for West Virginia University, where he is responsible for issues concerning taxation in state and local governments and tax-exempt entities. His background includes 15 years with the IRS and with OSU's tax-exempt bond activity. Hoffman, an enrolled agent and a certified financial planner, has a Master of Science in Taxation from Capital University in Ohio.

Maryann Motza, Denver, CO

Ms. Motza is the State Social Security Administrator of Colorado, where she works closely with all state and local governments' employers and their financial and legal advisors to ensure compliance with federal Social Security, Medicare, and public pension system laws. She is a Past President of the National Conference of State Social Security Administrators (NCSSSA) and member of the IRS's Taxpayer Advocacy Panel (2004 – 2007). She currently serves as a member of the Board of Trustees for the Public Employees' Retirement Association of Colorado (since 2005). Ms. Motza has a Ph.D. in Public Affairs from the University of Colorado.

GOVERNMENT ENTITIES: INDIAN TRIBAL GOVERNMENTS

Joe Lennihan, Santa Fe, NM

Mr. Lennihan is an attorney with one of the largest law firms in New Mexico. He has worked in the Tax Unit of the Navajo Nation Department of Justice and served as general counsel to the Colorado River Indian Tribes. He has also served as Chief Counsel to the New Mexico Taxation and Revenue Department. Mr. Lennihan received his LLM from Georgetown University Law School.

Dennis Puzz, Jr., Minneapolis, MN

Mr. Puzz is a member of the Yurok Tribe of Northern California and an attorney in the Native American Law section of Best & Flanagan LLP. Mr. Puzz focuses his practice on representing tribal governments in the areas of gaming, economic development, constitution, ordinance and regulation drafting, ICWA and employment. Prior to rejoining the firm, he was executive director of the Yurok Tribe, in Klamath, Calif. As executive director, Mr. Puzz oversaw all operations of the tribal government, which employs approximately 250 employees and operates on a yearly budget of \$12 million. He was also tasked with managing all Tribal Council initiatives internally, representing the Tribe on these issues with outside entities, and managing four outside law firm relationships regarding these projects. Mr. Puzz has a Juris Doctor from the University of Minnesota Law School.

Mary J. Streitz, Minneapolis, MN

Ms. Streitz is a partner in the law firm of Dorsey & Whitney LLP, with wide experience in a wide variety of tax issues affecting Indian tribal governments and other tribal entities. She has represented tribes in all regions of the country. She also heads up her firm's national Indian tax practice. Ms. Streitz has a Juris Doctor from the New York University School of Law.

GOVERNMENT ENTITIES: TAX EXEMPT BONDS

Michael G. Bailey, Chicago, IL

Mr. Bailey is a partner with Foley & Lardner in Chicago, specializing in public and tax-advantaged finance. He has represented a wide variety of state and local governments and exempt organizations. Mr. Bailey is the immediate past Chair of the Committee on Tax Exempt Financing of the Section of Taxation of the American Bar Association. From 1990 through 1997, he was senior attorney in the Office of the Chief Counsel of the IRS. Mr. Bailey holds a Juris Doctorate from the University of Chicago Law School.

Joan M. DiMarco, Philadelphia, PA

Ms. DiMarco is a managing director with PFM Asset Management LLC, where she serves as the co-director of PFM's Arbitrage Rebate Compliance Practice. She was a founding partner of BondResource Partners, LP, which joined the PFM Group in April 2009. Ms. DiMarco's background includes a wide range of experience in consulting to investment bankers, law firms, issuers and governmental agencies. She has more than 35 years of experience in municipal bonds and structured finance. Ms. DiMarco is a certified public accountant and has a Bachelor of Science in business administration from Drexel University.

John G. Pasicznyk, Albany, NY

Mr. Pasicznyk is the chief financial officer and treasurer of the Dormitory Authority of the State of New York, one of the largest issuers of tax-exempt debt and one of the largest public construction companies in the nation. In this position, Mr. Pasicznyk is responsible for all treasury, accounting, computer and information services functions related to administering a \$38 billion debt portfolio, including investments and arbitrage rebate compliance. He is also the Managing Director of the Authority's New York City Health and Hospitals Corporation (HHC) Construction Program. Before joining the Authority in 1985, Mr. Pasicznyk worked in audit positions at KPMG Peat Marwick and Deloitte Touche. Mr. Pasicznyk has a Bachelor of Science from Syracuse University and a Masters of Business Administration from the Duke University Fuqua School of Business.

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**GENERAL REPORT
OF THE
ADVISORY COMMITTEE ON TAX EXEMPT
AND
GOVERNMENT ENTITIES**

This General Report is presented in connection with the eighth annual public meeting of the IRS Advisory Committee on Tax Exempt and Governmental Entities (the “ACT”). The ACT members appreciate the opportunity to report to the Internal Revenue Service and the public regarding specific topics of interest with emphasis on the interaction of the Tax Exempt and Governmental Entities Division (TE/GE) of the Internal Revenue Service and its stakeholders. The individual reports from the ACT subcommittees representing Exempt Organizations, Employee Plans, Tax Exempt Bonds, and Federal State and Local Governments take on the form of specific recommendations to TE/GE culminating from diligent work for close to a year with TE/GE directors and staff as well as outside stakeholders. This year there are four (4) reports on the following topics:

- Exempt Organizations: Recommendations to Improve the Tax Rules Governing International Grantmaking
- International Pension Issues in a Global Economy: A Survey and Assessment of IRS’ Role in Breaking Down the Barriers
- Record Retention Requirements for Tax-Exempt Bonds and Tax Credit Bonds: A Specific Proposal for Published Guidance
- Federal-State-Local Government Compliance Verification Checklist for Public Employers

In reviewing the recommendations presented in each of the enclosed reports, it is important to note that the value of the recommendations depends substantially on the dialogue between the ACT, the Service and the various stakeholder groups about mutually important issues. The time that the ACT members dedicated to the projects went well beyond the bi-monthly meetings in Washington, DC. It is this ongoing dedication that continues to make the ACT a vital resource for the Service, and liaison for stakeholder groups and the public sector.

Each year approximately one-third of the twenty-one member ACT complete their term. The continuing members and I would like to thank them for their dedication and contributions, invaluable insights and lasting friendships. They are:

- Bonnie Brier, The Children's Hospital of Philadelphia
- Joan DiMarco, BondResource Partners LP
- Dodi Walker Gross, Reed Smith LLP
- Steve Hoffman, West Virginia University
- John Pasicznyk, Dormitory Authority of the State of New York
- Dennis Puzz, Best & Flanagan LLP
- Mary Streitz, Dorsey & Whitney LLP
- Ana Thompson, Charles and Helen Schwab Foundation

The ACT would like to thank Commissioner Douglas Shulman for his support of the ACT and its activities. A debt of gratitude also goes to former TE/GE Commissioner Steven T. Miller, TE/GE Deputy Commissioner Joseph Grant, TE/GE Directors Michael Julianelle, Lois G. Lerner, and Moises Medina, and many staff members who donated so much of their precious time to helping the ACT obtain relevant information and responding to the ACT's often challenging recommendations. On behalf of the ACT, I also want to welcome back Sarah Hall Ingram as the new TE/GE Commissioner.

The ACT would also like to thank Steve Pyrek, the ACT's Designated Federal Official, without whom none of us could have functioned as effortlessly and efficiently in Washington and between meetings. His organizational skills and willingness to guide and assist the ACT members in a friendly efficient manner is genuinely appreciated.

There have been many successful business partnerships over the years...the Wright Brothers and Hewlett and Packard to name a few. To succeed, a partnership between TE/GE and the ACT is critical. TE/GE's mission statement, says it all: "To provide TE/GE customers top quality service by helping them understand and comply with applicable tax laws and to protect the public interest by

applying the tax law with integrity and fairness to all.” The TE/GE-ACT partnership is another step toward meeting this goal.

Susan D. Diehl
Chairman

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**ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)**

**EXEMPT ORGANIZATIONS: RECOMMENDATIONS
TO IMPROVE THE TAX RULES GOVERNING
INTERNATIONAL GRANTMAKING**

Mary Rauschenberg, Project Leader

Fred Goldberg, Project Leader

Bonnie Brier

Karin Goldman

Jack Siegel

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June 10, 2009

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I know that we've only been in office for a little shy of a hundred days. But I'm even more convinced now than when I was when I became Secretary of State that the problems we face today will not be solved by governments alone... It will be in partnerships with philanthropy, with global business, partnerships with civil society. We have to find new ways to fill the space that is unfortunately left to create vacuums in too many places around the world.¹

Introduction

This year's project was selected in consultation with representatives of the IRS's Tax Exempt and Government Entities Division ("TE/GE") and responds to an IRS-wide initiative to address globalization. Newly appointed IRS Commissioner Douglas Shulman identified the "increasing globalization of tax administration" as one of his highest priorities:

Businesses are no longer defined by national borders. The cross border migration of capital and people has made this a more integrated world and the IRS needs to ensure it has the tax administration capabilities to deal with the fast pace of change.²

While the Commissioner's focus was primarily on challenges posed in a commercial context, his observation applies equally to the philanthropic sector.

Three decades ago, the primary examples of international philanthropy for many Americans were missionaries, the Red Cross, and "adopting" a child in an underdeveloped country for just pennies a day. In recent years, Bono, Presidents Carter, Bush, Clinton and Bush, Angelina Jolie, Oprah Winfrey, and countless other politicians, business leaders and celebrities have given their support to various international charitable causes.³ Star power has brought visibility, but the Bill and Melinda Gates Foundation and other foundations have brought billions of dollars to the table. We have seen a consortium of technology companies try to bring laptop

¹ Hillary R. Clinton, U.S. Sec'y of State, Remarks before the Global Philanthropy Forum (Apr. 30, 2009).

² Douglas R. Shulman, IRS Commissioner, Remarks Before the American Bar Association (May 9, 2008). Commissioner Shulman became the 47th IRS Commissioner on March 24, 2008.

³ It should be noted that politicians, business leaders and celebrities have long supported various charitable endeavors. For example, George Harrison with his August 1, 1971 concert for Bangladesh, Jerry Lewis' long support of the Muscular Dystrophy Association Telethon, Eleanor Roosevelt and Freedom House, etc.

computers to every child in the developing world.⁴ Similar efforts have been made in bringing pharmaceuticals and microfinance to the world's poor.

Events also have driven this trend. The 2005 tsunami in Southeast Asia saw an outpouring of money from the members of the public in the U.S. and other Western nations. When Hurricane Katrina hit New Orleans, we saw the world's generous response. At the same time, some have noted a link between charity and terrorism. This link often carries negative connotations, with the focus turning to how terrorists seek to hide behind purported "charities" to finance their violent activities.⁵ However, others assert that there can be a positive linkage. This group believes that one way to address the terrorist threat is to use carefully targeted initiatives in countries associated with terrorism to improve conditions in those countries, with the hope that the young people will turn their collective energy to more productive pursuits.

As the World Wide Web (the "Web") has reduced distances, people in the developed world find themselves unable to look away from the disease, poverty and strife that plague less developed areas of the world. The Web has had a similar effect on efforts to improve the planet's well-being. The result has been cross-border philanthropic efforts to address global warming, waterborne diseases, AIDS/HIV, and literacy. It is now possible for people in the U.S. to watch live international conferences such as the World Economic Forum in Davos, Switzerland, where these issues are discussed on a global stage. Once distant realities are now tangible. Many in the U.S. have responded by extending their hands and wallets beyond national borders. There is considerable focus today on enormous global challenges that confront all of humankind: the environment, health care, education, poverty and inequality, human rights, the mistreatment of women in many parts of the world, civil society and democracy movements, and national security—and to addressing these issues in new and innovative ways.

⁴ Steve Stecklow and James Bandler, *A Little Laptop with Big Ambitions*, Wall St. J., Nov. 24, 2007.

⁵ While these activities implicate the issue of tax exemption, they raise other, more significant law enforcement issues. Thus, for example, charities are covered by the scope of the Patriot Act and the government has devoted significant enforcement efforts in this area. While these activities respond to very real threats, we share the concern of others in the sector that the rules should avoid needlessly chilling certain types of philanthropic efforts. Thus, for example, it may be appropriate to clarify the "knowing" standard giving rise to criminal liability under the Patriot Act to make sure it is not triggered where charitable organizations are following Treasury Department guidelines, providing of emergency medical relief, and making broad-based community health care and educational services available.

The statistics bear out the anecdotal evidence. In 2007, U.S. foundations gave an estimated \$5.4 billion for international causes, up from \$1.6 billion in 1998.⁶ Much of this growth is attributable to the Bill and Melinda Gates Foundation, but by no means is all of it. From 2002 to 2006, international grantmaking exclusive of the Bill and Melinda Gates Foundation grew at 34.4% as compared to an overall 11.7% growth rate in foundation giving.

Private foundations are not the only organizations engaged in cross-border philanthropy. During 2007, other U.S. entities expended \$33.6 billion on philanthropic activities in the developing world. The other entities involved in this activity include corporations (\$6.8 billion), private and voluntary organizations (\$14.3 billion), colleges and universities (\$3.9 billion) and religious organizations (\$8.6 billion).⁷ By contrast, total U.S. official development assistance totaled \$21.8 billion.

Jonathan Fanton, the president of the John D. and Catherine T. MacArthur Foundation, recently remarked that “America has been the world leader in developing the independent sector at home and encouraging its growth abroad.”⁸ He continued by noting that, in his travels, he has observed that:

Americans are still warmly received, at least by the leaders in government, education, and the nonprofit sector with whom [his organization] works. That is partly because many of them have spent time here as students and know our country, our people, our values, directly. It is also because they have worked with [his] and other foundations, or with U.S.-based NGOs . . .⁹

Fanton then noted the international philanthropic work of U.S.-based charities provides “reassurance that the United States will remain true to its history as a beacon of hope, freedom, fairness, and respect for international law.”¹⁰

In recent years, the world has seen a new breed of organization proliferate. So-called public-private partnerships are often focused on global issues and intent on making a substantial impact on conditions in developing countries. The *Index of Global Philanthropy 2008* observed this trend:

⁶ Foundation Center, *International Grantmaking IV Highlights* (2007).

⁷ Center for Global Prosperity, Hudson Institute, *The Index of Global Philanthropy* (Apr. 2009). The basis for measuring this activity differs from that employed by the Foundation Center. This second set of data included just \$3.3 billion of expenditures by foundations, which differs significantly from the \$5.4 billion reported by the Foundation Center.

⁸ Jonathan F. Fanton, President of the John D. and Catherine T. MacArthur Foundation, Remarks before the Independent Sector (Nov. 6, 2004).

⁹ *Id.*

¹⁰ *Id.*

Global [p]hilanthropy is becoming a truly world wide phenomenon. Over the last two decades, the United States and Europe have led the dramatic growth in philanthropy and remittances to developing countries... The traditional “donor-to-recipient” model of foreign aid has been supplemented, if not supplanted, by public[-]private partnerships. The roles played by business, governments, charities and workers sending remittances back home have changed... Whatever it is called—social entrepreneurship, philanthrocapitalism, venture philanthropy, or...creative capitalism – the lines between business and philanthropy continue to blur... [The programs] focus on homegrown solutions by local entrepreneurs and grassroots organizations that work with their peers from developed countries in real partnerships, not as donors and recipients.¹¹

Recognizing these dynamic developments and in keeping with Commissioner Shulman's focus, we surveyed the tax issues surrounding cross-border philanthropy. Our primary goals in pursuing this project were to identify significant tax issues confronting cross-border philanthropy and to develop specific proposals to address those issues, with a focus on areas that the IRS can address through administrative action. We consulted with more than 30 stakeholders, including representatives of organizations active in a broad range of cross-border charitable activities (including U.S.-based and international public charities and private foundations) along with practitioners, advocacy groups, academics and government representatives. These individuals and groups are identified at Appendix A of this report.

¹¹ Center for Global Prosperity, *Index of Global Philanthropy 2008*, <https://www.hudson.org/files/documents/2008percent20Indexpercent20percent20Lowpercent20Res.pdf> (last visited Apr. 7, 2009).

Overall Observations and Conclusions

Cross-border philanthropy is a vibrant and vital aspect of the American tradition of giving. It is an area of the tax law where the basic framework functions reasonably well and where structural compliance risks appear to be relatively modest. However, much of the guidance is decades old. Although grantmakers have been able to pursue legitimate activities, technical issues that have gone uncorrected unnecessarily increase the costs and impede legitimate transactions. We believe an update to the rules is warranted.

The following is a summary of our observations and conclusions:

1. *Charitable endeavors that extend beyond our borders have long been part of the American approach to philanthropy.* For almost a century,¹² the tax law has embraced cross-border philanthropy by permitting U.S. charities to pursue their objectives in all corners of the globe and by generally providing income and transfer tax deductions for contributions to U.S. charities that go to support those efforts.¹³
2. *By and large, the tax law and tax administration have functioned well in addressing the special challenges of cross-border philanthropy.* As in many other areas of international tax law (e.g., foreign tax credits, transfer pricing, expatriate taxation, etc.), the rules applicable to cross-border philanthropy are complex. Nonetheless, we share the view expressed by those with whom we spoke that the basic tax law framework governing cross-border philanthropy is fundamentally sound and that no major overhaul is necessary.
3. *There is nothing we have learned based on information available at the present time to suggest that international philanthropy is especially or uniquely susceptible to widespread tax avoidance.* During the past decade, there have been widely publicized instances where charities have been used (knowingly or otherwise) to facilitate tax avoidance schemes that have

¹² As early as 1920, the IRS ruled that a U.S. organization building World War I museums in Europe could qualify as exempt based on its educational mission and project. A.R.R. 301, 3 C.B. 188 (1920). The IRS reaffirmed this conclusion in both informal and formal guidance over the next several decades in the context of specific charitable activities, and in 1971 stated a rule of general application: “since a [domestic corporation’s] activities are charitable within the meaning of section 501(c)(3) of the Code when carried on within the United States, the conduct of such activities elsewhere does not preclude the organization from qualifying as an exempt organization under that section.” Rev. Rul. 71-460, 1971-2 C.B. 231.

¹³ Charitable contributions eligible for deduction under § 170 of the Internal Revenue Code (the “Code”) must be made to U.S. organizations. In addition, contributions by corporations can only be used outside the U.S. if the charitable recipient is a corporation. Code § 170(c)(2) (2009). The Code does permit transfer tax deductions for contributions made directly to non-U.S. charities. Code §§ 2522(a)(2); 2055(a)(2) (2009).

prompted IRS enforcement efforts and legislative changes.¹⁴ It is important to note in the context of our report, however, that these particular compliance risks are a function of a charity's exempt status and are not affected by whether the charity is engaged in cross-border charitable activities.¹⁵ Those with whom we consulted who expressed views on the subject suggested that the nature of the international philanthropic activities and the parties performing those activities are such that the risks of widespread noncompliance are relatively modest. We encourage the IRS to maintain an enforcement presence in this area (and to establish such a presence to the extent it does not currently exist).¹⁶ However, it does not appear to be an area requiring a substantial and disproportionate allocation of enforcement and regulatory resources to address.

4. *While the longstanding framework for cross-border philanthropy functions well, it can and should be updated to simplify compliance and clarify areas of uncertainty.* Much of the guidance affecting cross-border philanthropy was provided long ago and fails to reflect developments of the past 15 or more years. As such, it does not address certain practices and structures that are common today. It is our belief that a modest expenditure of IRS and Treasury administrative resources spent making updates to certain guidance will yield an exceptionally high return by reducing compliance burdens, improving charitable organizations' ability to comply with our tax rules and enhancing their ability to fulfill charitable missions beyond our borders. We recommend that the government make this investment, and are confident that a broad array of stakeholders will contribute time and energy to facilitating the effort.

¹⁴ The IRS Web site lists abusive transactions involving charities. The list includes (i) the assignment of offsetting foreign currency options to a charity to claim substantial artificial losses; and (ii) abusive trust tax evasion schemes that sometimes involve a charity. The complete list of abusive transactions involving exempt organizations is available at <http://www.irs.gov/charities/article/0,,id=128722,00.html> (last visited May 7, 2009).

¹⁵ There are, of course, instances of non-compliance in the context of cross-border philanthropy, as in all areas of the tax law. We also recognize that detection and enforcement may be more difficult because the questionable activities (e.g., private benefit or private inurement) may take place outside our borders. However, none of those with whom we consulted expressed the view that within a cross-border context, non-compliance with the tax laws is either widespread or systemic. (There is considerable focus on the extent to which charities may be using the cloak of charitable status to promote or support terrorist activities. This concern implicates law enforcement issues that are more fundamental than compliance with tax-specific requirements and are beyond the scope of this report.)

¹⁶ The information being gathered by the IRS on the new Form 990, Return of Organization Exempt From Income Tax, and Schedule F, Statement of Activities Outside the United States, should facilitate these efforts both with respect to organizations with overseas operations and organizations which are making grants to foreign organizations.

Specific Recommendations

While we heard many recommendations for additional guidance, we focused on those that we believe will make a significant impact on cross-border philanthropy (either through enhanced compliance or relief of burden), can be implemented administratively by the IRS and can be done without consuming significant government resources. We recommend that the IRS:

1. *Equivalency Determinations—Repository Proposal.* Facilitate formation of Equivalency Determination Information Repositories (“EDIRs”) which would make equivalency determinations in accordance with the requirements of Revenue Procedure (“Rev. Proc.”) 92-94 (as updated from time to time) and procedures approved by the IRS that could be relied on by other charities.
2. *Public Support Test for Equivalency Determination Purposes and for Applying the Public Support Tests Pursuant to §§ 509(a)(1) and (2).*¹⁷ Publish guidance providing that for purposes of applying the foreign equivalency provisions of § 4945(d)(4)(A)(i) and Treas. Reg. § 53.4945-5(a)(5), and for purposes of applying the public support tests under §§ 509(a)(1) and (2), grants from the following sources are treated as grants from § 509(a)(1) organizations:
 - a. Foreign governments (excluding foreign governments on the list of sanctioned countries put forth by the Office of Foreign Assets Control (“OFAC”));
 - b. International organizations designated by executive order pursuant to 22 U.S.C. § 288¹⁸; and
 - c. Foreign organizations for which a good faith determination has been made that the grantor is an organization described in § 509(a)(1).
3. *Expenditure Responsibility Rules.* Simplify and enhance application of the expenditure responsibility requirements imposed by § 4945 by providing safe harbor reporting periods for grants of capital assets or used to acquire capital assets.

¹⁷ Unless otherwise indicated, all section references from this point forward are to the Code of 1986, as amended, or to the Treasury regulations thereunder.

¹⁸ 22 U.S.C. § 288 (2009).

4. *Program-Related Investment Rules.* Update guidance under the program-related investment rules by providing additional examples of permitted program-related investments, focusing on international activities and using the 2002 recommendations from the Committee on Exempt Organizations of the American Bar Association Section on Taxation and its Task Force on Program-Related Investments (“PRI Task Force”).

Each of these recommendations has a direct impact on the international activities of private foundations. As described below, we believe that each one has significant potential to improve compliance while reducing compliance costs and enhancing philanthropic efforts outside the U.S.¹⁹

¹⁹ While we recognize that recommendations (2), (3) and (4) will have application to domestic as well as international activities by private foundations, we have included them in our report because of their importance in the international context. Moreover, we believe that the recommendations are equally appropriate in the domestic context on technical, administrative and policy grounds.

In addition, we note that our recommendations have direct application to private foundations. Based on our interviews with public charities having activities outside the U.S. and their advisors, two issues did emerge. First, as discussed above, they highlighted the same concern raised by private foundations concerning the chilling impact of the legislation known as the “Patriot Act” and its implementation by Treasury. The second area they identified focused on the activities of a limited number of large organizations with truly global operations. Here, the concerns focused on the need for reforms such as uniform and consolidated financial accounting and bilateral and multilateral treaty arrangements designed to harmonize certain charitable rules. While these concerns are legitimate and growing based on information we received, they raise complex questions and are well beyond the scope of the IRS and Treasury acting on unilateral bases. As a result, we believe these concerns are beyond the scope of this report.

General Background

Each of our recommendations deals with an aspect of the requirements coming out of the Tax Reform Act of 1969 (the “1969 Act”). That legislation established a detailed framework for regulating private foundations that expands on the rules otherwise applicable to all charities. As explained in more detail below:

- *Minimum Distribution Requirements.* Section 4942, implemented in the 1969 Act, added the requirement that nonoperating private foundations distribute amounts equal to five percent of their noncharitable-use assets. Among other things, § 4942 provides rules for when grants to certain organizations (generally, public charities and public charity equivalents) are qualifying distributions for this purpose. Further, § 4942(g)(1)(B) provides that investments held in furtherance of a charity’s exempt purpose may be treated as qualifying distributions for purposes of the minimum distribution requirements. Section 4942 imposes punitive excise taxes on a foundation for violating its minimum distribution requirement, with potential liability extending to the foundation’s managers.
- *Prohibition on “Taxable Distributions.”* Section 4945, implemented in the 1969 Act, prohibited foundations from making “taxable distributions.” Among other things, § 4945 provides that private foundations are in compliance with these requirements either by making grants to certain types of organizations (generally, public charities and public charity equivalents), or by exercising “expenditure responsibility” with respect to their grants. Section 4945 imposes punitive excise taxes on a foundation for violating the prohibition on taxable expenditures, with potential liability extending to the foundation’s managers.
- *Excess Business Holdings.* Section 4943, implemented in the 1969 Act, limited the extent to which private foundations may own businesses. One of the exceptions to this rule provides that “program-related investments” are not considered a business holding subject to the § 4943 limitations. Thus, investments that are substantially related to the foundation’s exempt purpose (aside from the need to produce income) are not subject to the excess business holdings limitations.²⁰
- *Jeopardizing Investments.* Section 4944 of the 1969 Act prohibited private foundations from making “jeopardizing investments” -- generally, investments that “may jeopardize the carrying out of exempt purposes” by failing to “provid[e] for the long- and short-term financial needs of the foundation.”²¹ In addition, § 4944 provides that program-related investments do not constitute jeopardizing investments.

²⁰ Treas. Reg. § 53.4943-1.

²¹ Treas. Reg. § 53.4944-1(a)(2).

By 1973, the IRS and Treasury had provided substantial regulatory guidance in each of these areas, with the exception of jeopardizing investments.

As in many areas of the tax law, the rules are detailed and complicated. For our purposes, however, the grantmaking framework is rather straightforward. In its foreign grantmaking activities, a private foundation effectively must grant to one of the following:

- (a) A foreign organization that has been determined to be equivalent to a U.S. public charity (i.e., the organization must meet the charitable standards of § 501(c)(3), and must meet the public support tests of § 509 such that it would not be treated as a private foundation for U.S. tax purposes) (an “equivalency determination”);
- (b) A foreign government or instrumentality or agency thereof; or
- (c) An international organization designated as such by executive order pursuant to 22 U.S.C. § 288.²²

Otherwise, the private foundation must exercise expenditure responsibility over its grant. In other words, private foundations must either make an equivalency determination or exercise expenditure responsibility in their foreign grantmaking (unless one of the governmental or international organization rules applies).

The IRS and Treasury have not updated the regulations issued during the early 1970s and have provided little precedential guidance since that time. The one action taken was an effort to simplify equivalency determinations in 1992 through issuance of Rev. Proc. 92-94 setting forth a “simplified” safe harbor method for making such determinations.

During the intervening years, various stakeholders have encouraged the IRS and Treasury to address rules that were promulgated more than 35 years ago. Thus, for example, in 1984, Congress instructed the IRS and Treasury to review the expenditure responsibility rules with a view to simplifying them. Thereafter, in connection with the issuance of Rev. Proc. 92-94, there was an expectation (or hope) in some quarters that the IRS itself would begin making equivalency determinations of benefit to grantmaking organizations, or that one or more private sector initiatives would lead to some kind of repository or equivalency library conferring similar benefits.

²² It should be noted that a number of organizations not based in the U.S. have obtained determination letters from the IRS reflecting their public-charity status. Pursuant to Treas. Reg. § 53.4945-5(a)(1), for purposes of private foundation grantmaking activities, these organizations are treated as U.S. public charities.

In 2002, the PRI Task Force urged the IRS and Treasury to provide additional examples of activities satisfying the program-related investment rules, with a particular emphasis on international programs.

In some cases, these suggestions reflect difficulties that have emerged with the rules as they were originally promulgated. In other cases, they reflect the growth in foreign grantmaking activities and changes in the nature and conduct of international philanthropy. As referenced at the outset of our report, we believe these are important trends that will continue and accelerate. In our view, and the view of those with whom we consulted, these steps will have significant impact in improving compliance while reducing compliance burdens and improving the efficiency and effectiveness of international philanthropy. We also note that the IRS has authority to implement our first recommendation and that the IRS and Treasury have the authority to implement the other three. While we recognize that all guidance projects require a meaningful investment of resources by the IRS and Treasury, we believe that our recommendations can be implemented with a relatively modest expenditure of resources both because they are narrowly focused and because of the substantial ongoing efforts in the charitable sector to address these issues.

Recommendation 1: Equivalency Determinations–Repository Proposal

We encourage the IRS to facilitate formation of EDIRs which would make equivalency determinations in accordance with the requirements of Rev. Proc. 92-94 (as updated from time to time) and procedures approved by the IRS that could be relied on by other charities.

In furtherance of this recommendation, we encourage the IRS to give high priority attention to the proposal of the Council on Foundations and TechSoup Global and any other organization seeking to establish an EDIR. We have not reviewed this proposal and express no views regarding its merits. However, we believe that it presents an opportunity for the IRS to develop standards for EDIRs. Ultimately the IRS should publish guidance regarding standards and procedures for EDIRs to obtain IRS approval.

Background. To avoid excise taxes under § 4945, private foundations must exercise expenditure responsibility when making grants to foreign organizations that have not obtained a § 501(c)(3) determination letter classifying them as public charities (other than so-called “nonfunctionally integrated type III supporting organizations”).²³ Similarly, to avoid tax under § 4966, sponsoring organizations of

²³ § 4945(d)(4)(A).

donor-advised funds must exercise expenditure responsibility over distributions to foreign organizations that have not obtained determination letters classifying them as described in §§ 170(b)(1)(A) or 509(a)(2). As an alternative to exercising expenditure responsibility, the regulations permit private foundations to make their own “equivalency determinations” as to their grantees’ tax classification in lieu of relying on an IRS determination letter.²⁴ The legislative history to § 4966 indicates that the same option will be available to donor-advised funds. An equivalency determination can be based upon either (i) an opinion from legal counsel that the foreign corporation is described in § 501(c)(3) and is a public charity or (ii) an affidavit from the foreign organization that the private foundation can use to make its own determination that the foreign organization is the equivalent of a § 501(c)(3) public charity.

Equivalency determinations present a particular set of challenges for international grantmakers. Until 1992, foundations that relied on equivalency determinations had no practical guidance from the IRS regarding when a foreign organization qualified as the equivalent of a § 501(c)(3) organization. Since 1978, the IRS has only issued approximately 20 private letter rulings with a reference to Treas. Reg. § 53.4945-5(a)(5), which creates the equivalency determination option. While many of these rulings involve grants to foreign organizations, we were told that many foundations rely on a combination of opinions of counsel and affidavits from the foreign organization rather than private letter rulings.²⁵

In 1992, the IRS issued Rev. Proc. 92-94 to provide guidance to taxpayers regarding equivalency determinations. The Rev. Proc. sets forth a “simplified” procedure that private foundations may use to make equivalency determinations with regard to foreign organizations.²⁶ In essence, the Rev. Proc. provides one method by which private foundations ensure that their grants qualify as qualifying distributions under § 4942 and are not taxable expenditures under § 4945.

The Issue. Despite the IRS’s well-intentioned efforts when it issued Rev. Proc. 92-94, equivalency determinations continue to be time-consuming and costly. In many instances, multiple charities obtain affidavits or opinions of counsel with respect to the same foreign organization. The result is duplicative costs and a potential lack of uniform standards.

Rationale for Recommendation (General). We believe that the establishment of one or more EDIRs will reduce the overall cost of obtaining equivalency determinations by making the same determination available to multiple parties and through the development of institutional experience and expertise. We also believe that EDIRs will enhance compliance through higher quality and more consistent

²⁴ Treas. Reg. § 53.4945-5(a)(5); Treas. Reg. § 53.4942(a)-3(a)(6).

²⁵ Treas. Reg. § 53.4942(a)-3(a)(6). Treas. Reg. § 53.4945-5(a)(5).

²⁶ Rev. Proc. 92-94, 1992-2 C.B. 507.

determinations.²⁷ At the time Rev. Proc. 92-94 was issued, the IRS suggested that “grantors could rely on an affidavit or opinion about a particular recipient prepared by another grantor” under the procedure,²⁸ but no mechanism was developed by either the IRS or the charitable sector to enable that sharing to occur. With the growth in global grantmaking, the need for such arrangements has become more pressing. But without IRS assurance that individual grantmakers can appropriately rely on an EDIR’s collected information and equivalency determinations, many grantmakers will likely feel constrained to continue performing their own equivalency determinations for foreign grantees.

Rationale for Recommendation (Council on Foundations). One such effort began several years ago when the Council on Foundations (the “Council”) entered into a collaboration with the Foundation Center, Independent Sector and InterAction to develop and implement an EDIR.²⁹ The collaboration has been supported by grants from the Amgen Foundation, Annenberg Foundation, BP Foundation, Carnegie Corporation of New York, Christensen Fund, Firelight Foundation, Bill and Melinda Gates Foundation, GE Foundation, F.B. Heron Foundation, William and Flora Hewlett Foundation, W.K. Kellogg Foundation, Kresge Foundation, John D. and Catherine T. MacArthur Foundation, Rockefeller Brothers Fund and Rockefeller Foundation.³⁰ On November 6, 2008, it was announced that TechSoup Global was selected as the repository administrator by a review panel of experts and foundations assembled by the Council.

According to its website, TechSoup Global is an organization that “bring[s] technological empowerment and philanthropy to social benefit organizations—including nonprofits, nongovernmental organizations, libraries and other social change agents.”³¹ The goal of the EDIR is to

[s]erve as a platform to streamline the process of qualifying non-U.S. grantees as the equivalents of U.S. public charities, also known as an equivalency determination (ED) process, one of the principal

²⁷ As a group, we have debated whether an EDIR should be limited to § 501(c)(3) organizations (either all charities or just public charities), to other exempt organizations as well, or whether an EDIR could be effectively operated in a profit organization. Some were drawn to the thought that the IRS might provide oversight if conducted in a § 501(c)(3) organization, while others felt this was a level of oversight that is unnecessary.

²⁸ James F. Bloom, Edward D. Luft & John F. Reilly, *Foreign Activities of Domestic Charities and Foreign Charities*, 21, FY 1992 EO CPE Text.

²⁹ It should be noted that while we wholeheartedly endorse the concept of EDIRs, we do not specifically endorse either the Council or its proposal.

³⁰ Information Age Associates, *Repository of Equivalency Determination (ED) Information on Non-U.S. Based NGOs*, <http://www.iaa.com/ngorepository.html> (last visited May 5, 2009).

³¹ TechSoup Global, *About Us*, <http://www.techsoupglobal.org/about-us> (last visited Apr. 5, 2009).

ways prescribed by the IRS for making cross-border grants.³²

It is anticipated that the repository will be launched by the end of 2010.³³

As part of a feasibility study on the formation of this EDIR, Information Age Associates conducted a survey to gain information regarding the importance of the EDIR initiative to the sector. The survey reported that of those responding, 86% of grantmakers and 75% of service providers responded that the availability of a centralized repository of vetted non-U.S.-based NGO information would be a significant benefit to U.S. philanthropy. In addition, 98% of NGOs responded that they would submit key information about their organizations and officers to a central repository and keep it up-to-date. Further, 77% of grantmakers agreed that a letter ruling from the IRS approving the centralized repository would be a key factor in their decision to become a member.³⁴

It is our understanding that a private letter ruling request regarding this EDIR was recently submitted to the IRS.³⁵ We have not reviewed that request and take no position one way or the other on its merits. However, we believe the private letter ruling process is the proper vehicle for this purpose because it permits the IRS to explore the concept in as much detail as it believes appropriate. Once the IRS is comfortable with the concept, it should provide guidance in a Rev. Proc. so that other interested parties can establish EDIRs. Another group, for example, might want to establish an EDIR focused on a particular type of philanthropy (e.g., health care or the environment) or a particular country or region of the world (e.g., Ireland or sub-Saharan Africa).

Recommendation 2: Characterization of Support From Certain Foreign Organizations as Unrestricted Public Support

We recommend that the IRS and Treasury publish guidance providing that for purposes of applying the foreign equivalency provisions of Treas. Reg. § 4945(d)(4)(A)(i) and Treas. Reg. § 53.4945-5(a)(5), and for purposes of applying the public support

³² TechSoup Global, *TechSoup Global to Host New Centralized Repository to Better Enable International Philanthropy*, <http://www.techsoupglobal.org/press/pressreleases/globalrepository> (last visited Apr. 5, 2009).

³³ *Id.*

³⁴ Information Age Associates, *Potential of Creating a Centralized Repository of Information on Non-U.S. Based NGOs: Findings and Recommendations*, December 2006, <http://www.iaa.com/resources/NGOFeasibilityStudyFindingsandRecommendations-Dec2006.pdf> (last visited May 5, 2009).

³⁵ Information Age Associates, *NGO Repository Project Update: Establishing a Centralized Repository of Equivalency Determination Information on Non-U.S. Based NGOs*, <http://www.iaa.com/resources/NGORepositoryPresentation-March2009.pdf> (last visited May 5, 2009).

tests under §§ 509(a)(1) and (2), grants from the following sources are treated as grants from § 509(a)(1) organizations:

- 1. Foreign governments (excluding foreign governments on the OFAC list of sanctioned countries);³⁶*
- 2. International organizations designated by executive order pursuant to 22 U.S.C. § 288; and*
- 3. Foreign organizations for which a good faith determination has been made that the grantor is an organization described in § 509(a)(1).*

Background: Private Foundation Status.³⁷ The Code draws important distinctions between public charities and private foundations, both with respect to the deductibility of charitable contributions they receive and how their activities are regulated. Rules governing the deduction of contributions to private foundations are more restrictive,³⁸ and their activities are heavily regulated through the private foundation excise tax rules of §§ 4941-4946.³⁹

³⁶ It has been suggested that we include an OFAC carve-out as a way of acknowledging concern over terrorist and rogue nation activities. Others suggest that it is not necessary and would create serious practical difficulties (e.g., would it be necessary to track indirect contributions?).

³⁷ The primary provisions addressing public charity and private foundation status are contained in §§ 509(a), 170(b)(1)(A) and 170(c) and the regulations thereunder. These rules are quite detailed and complex. Useful descriptions can be found in the following treatises: Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* (9th ed. 2007); Bruce R. Hopkins and Jody Blazek, *Private Foundations: Tax Law and Compliance* (2d ed. 2003), Frances R. Hill and Douglas Mancino, *Taxation of Exempt Organizations* (2002).

³⁸ To take some examples, the adjusted gross income limitation on charitable contribution deductions is lower for contributions to private foundations in § 170(b)(1)(B). Deductions for contributions of tangible personal and real property generally are limited to tax basis unless the private foundation is an operating foundation or qualifies as a conduit or common fund foundation under § 170(b)(1)(A)(vii). Under § 170(e)(5), there are various conditions that must be met to deduct the fair market value of stock contributed to a private non-operating foundation.

³⁹ Section 4941 imposes sanctions on self-dealing transactions; § 4942 imposes sanctions on failures to satisfy minimum distribution obligations; § 4943 imposes sanctions on excess business holdings; § 4944 imposes sanctions on jeopardizing investments; and § 4945 imposes sanctions on “taxable expenditures” (grants where a private foundation fails to exercise expenditure responsibility or fails to make a good faith determination that the organization is equivalent to a §§ 509(a)(1), (2), or (3) organization). Section 4946 defines certain terms used in §§ 4941-4945, including “disqualified persons” (Treas. Reg. § 4946-1(a)) and “foundation managers” (Treas. Reg. § 4946-1(f)). Disqualified persons include substantial contributors and foundation managers, those with significant ownership interests in substantial contributors, organizations in which substantial contributors and foundation managers have substantial ownership interests, and family members of the foregoing. In general, a substantial contributor is defined in § 507(d)(2) as any contributor who provides more than two percent of the total contributions to the organization. A substantial contributor remains a substantial contributor unless, during any consecutive 10-year period: (i) neither the contributor nor any related person

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An organization described in §§ 509(a)(1) or (2) is not a private foundation.⁴⁰ In general, § 509(a)(1) organizations are: (1) charities whose activities are viewed as inherently “public” in nature (such as churches, schools and hospitals) (often known as “*per se* public charities”); (2) domestic governmental units (the U.S. and its possessions, states, and the District of Columbia, including political subdivisions); and (3) charities that normally derive a substantial part of their support from the public (often known as “publicly supported charities”).⁴¹ § 509(a)(2) organizations are charities that normally derive a substantial part of their support from the performance of their exempt purposes, together with gifts, grants and contributions from the public (often known as “activity-supported charities”).⁴²

In the case of § 509(a)(1) publicly supported charities, the regulations impose a two-percent limit on the amount of gifts, grants and contributions from the public that can be taken into account in computing the level of public support. Generally, this limitation does not apply to support received by § 509(a)(1) organizations from other §§ 509(a)(1)/170(b)(1)(A)(iv) organizations.⁴³

In the case of § 509(a)(2) activity-supported charities, the regulations restrict gifts, grants, contributions and program service revenue from disqualified persons (substantial contributors and other disqualified persons). § 509(a)(1) has no such limitation. In addition, § 509(a)(2) imposes a one percent limitation on contribution and program service revenue received from individuals and organizations that are not disqualified persons. Generally, the one percent limit does apply to support received from organizations described in § 509(a)(1).⁴⁴

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makes additional contributions to the organization; (ii) neither the contributor nor any related person is a foundation manager of the organization; and (iii) contributions from the substantial contributor and related persons are “insignificant” when compared to contributions by any one other person.

⁴⁰ § 509(a) also provides that supporting organizations described in § 509(a)(3) and organizations that test for public safety (§ 509(a)(4)) are not private foundations. Recently enacted legislation does subject so-called “non-functionally-integrated-type III” supporting organizations and donor-advised funds to certain of the private foundation rules (e.g., §§ 4943(e) and (f)).

⁴¹ §§ 170(b)(1)(A) (other than clauses (vii) and (viii)) and 509(a)(1). See also Treas. Reg. §§ 1.170A-9 and 1.509(a)-2 as well as the 2008 instructions to Schedule A of the Form 990.

⁴² § 509(a)(2). See also Treas. Reg. § 1.509(a)-3 and the 2008 instructions to Schedule A of the Form 990.

⁴³ The two-percent limitation does not apply to contributions or grants from organizations that are non-private foundations pursuant to §§ 509(a)(1)/170(b)(1)(a)(iv), governmental units described in 170(b)(1)(A)(v) and other organizations, such as the following, but only if they also qualify as publicly supported organizations under § 170(b)(1)(A)(iv): churches described in § 170(b)(1)(A)(i), educational institutions described in § 170(b)(1)(A)(ii), and hospitals described in § 170(b)(1)(a)(iii).

⁴⁴ Treas. Reg. § 1.509(a)-3(j)(1).

For convenience, gifts, grants, contributions and other forms of support that are subject to the two-percent and one-percent or disqualified-person limitations of §§ 509(a)(1) and (2) are hereafter referred to as “limited” and support that is not subject to those limitations is referred to as “unlimited.”

Background: Grants from U.S. Private Foundations to Foreign Organizations.

Treas. Reg. §§ 53.4945-5(a)(4) and (5) provide that grants to the following organizations will not be subject to the expenditure responsibility requirements of § 4945: (1) a foreign charity, if the private foundation makes a good faith determination that the organization is described in §§ 509(a)(1), (2) or (3); (2) a foreign government, including agencies and instrumentalities thereof; and (3) an international organization designated as such by executive order pursuant to 22 U.S.C. § 288 even if not otherwise described in § 501(c)(3). Examples of organizations so designated include the United Nations, UNICEF, UNESCO, the World Bank and the International Monetary Fund.

The Issue: Characterization of Support from Foreign and Designated Multinational Organizations.

If a U.S. charity receives support from a foreign organization, it must determine whether that support is limited or unlimited. Likewise, if a U.S. private foundation is making a § 4945 equivalency determination in connection with a grant to a foreign charity that receives support from other foreign organizations, it must determine whether that foreign organization support is limited or unlimited. This issue arises in three circumstances: i) grants from foreign organizations that have not received determination letters from the IRS but are equivalent to § 509(a)(1) *per se* or publicly supported charities; (ii) support from foreign governments; and (iii) support from international organizations designated by executive order.

Grants from Per Se and Publicly Supported Foreign Charities. While the IRS and Treasury have provided no published guidance that is directly on point, it is generally accepted that grants from foreign organizations that are equivalent to § 509(a)(1) organizations are not limited in determining whether the recipient charity is described in §§ 509(a)(1) or (2).⁴⁵ This conclusion applies to support provided to U.S. charities (where the issue is determining their status under §§ 509(a)(1) or (2)), and support provided to foreign charities (where the issue is making equivalency determinations).

- *Grants from Foreign Governments.* In 1975, shortly after the private foundation rules were enacted in 1969, the IRS and Treasury provided guidance regarding

⁴⁵ While there is no published authority specifically addressing this question, Treas. Reg. § 1.509(a)-2(a) (a charitable organization described in § 170(b)(1)(A)(i)-(vi) is not a private foundation despite failing to satisfy the requirements of § 170(c)(2) because it is a foreign organization) and Treas. Reg. § 53.4945-5(a)(5) support this conclusion. It is also supported by the holding and rationale of Rev. Rul. 75-435, 1975-2 C.B. 215, discussed below, as well as the policies giving rise to the private foundation rules.

the treatment of support provided by a foreign government to a foreign charity.⁴⁶ The ruling concluded that “[a]n exempt organization organized in a foreign country and receiving a substantial portion of its support from a foreign government is not a private foundation as defined in § 509(a) of the Code.”⁴⁷ The ruling does not contain geographic limitations (i.e., the holding is not limited to support provided by foreign country A to a charity organized in foreign country A). While not addressed on the facts in the ruling, the ruling’s rationale applies with equal force to grants by a foreign government to a U.S. charity for purposes of determining whether the recipient is described in § 509(a)(1) or (2).

Unfortunately, internal exchanges between two IRS offices in 1977 and 1980 cast something of a cloud over Rev. Rul. 75-435 when they were subsequently released during the 1980s.⁴⁸ Nonetheless, Rev. Rul. 75-435 has now been outstanding for 34 years and should be controlling authority regarding the treatment of support provided by foreign governments.

- *Support From International Organizations Designated by Executive Order.* Unlike the situation involving foreign governments, there is no guidance providing that designated organizations are not treated as private foundations. In the absence of such guidance, support provided by such organizations is limited.

Need for Guidance. During our review, we heard repeatedly that there is pressing need for guidance regarding the characterization of support from foreign governments, foreign charities that are equivalent to *per se* and publicly supported charities described in § 509(a)(1) and multinational organizations.⁴⁹ We will refer to these organizations as “Non-U.S. Public Organizations.”

⁴⁶ Rev. Rul. 75-435

⁴⁷ Issuance of the ruling was approved by the Interpretative Division of the Office of Chief Counsel in G.C.M. 36115 (Dec. 20, 1974).

⁴⁸ In G.C.M. 37001 (Feb. 10, 1977), the Interpretative Division of the Office of Chief Counsel did not approve of a ruling that the Assistant Commissioner (Employee Plans and Exempt Organizations) proposed issuing that would have explicitly extended Rev. Rul. 75-435 to support provided by foreign governments to U.S. charities. Thereafter, in G.C.M. 38327 (Mar. 31, 1980), the Interpretative Division “tentatively” concluded that Rev. Rul. 75-435 was incorrectly decided under the existing regulations, while concurring that the ruling should not be withdrawn and maintaining that the issue of foreign government support should be addressed in regulations. No action has been taken during the intervening 29 years and Rev. Rul. 75-435 remains outstanding.

⁴⁹ As evident from Rev. Rul. 75-435, the question of how to treat foreign government support of foreign charities has been an issue since the private foundation regime was first enacted. The ruling was a timely response to the fact that in many other parts of the world, governments have been a primary source of support for foreign charitable organizations. The same applies for grants from private foundations to foreign organizations, as evident from Treas. Reg. §§ 53.4945-5(a)(4) and (5). While these issues have been around for decades, they have

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As an immediate and practical matter, EDIRs require guidance on these issues to make appropriate equivalency determinations. Likewise, donor-advised funds and supporting organizations were recently made subject to the expenditure responsibility rules—they, too, need guidance on these issues. More generally, as noted at the outset of our report, cooperative efforts by nations, multinational organizations, and U.S. and foreign charities are increasingly common in efforts to address natural disasters and global challenges relating to the environment, health care, education, poverty and inequality, genocide, human trafficking and discrimination and civil society and security. The funding arrangements associated with these activities inevitably raise the question of how to characterize support provided by Non-U.S. Public Organizations under current law and as a policy matter.

Rationale for Recommendations. There was widespread agreement among private foundations, advisors and academics with whom we spoke regarding the following:

(1) grants from foreign charities that are equivalent to *per se* and publicly supported charities as described in § 509(a)(1) likely are and certainly should be treated for all purposes as unlimited; (2) support from foreign governments is and should be treated for all purposes as unlimited; and (3) while support from designated multinational organizations is currently limited, this result is not compelled by the statute, is inconsistent with policies underlying the private foundation rules, and should be changed. They further observed that while the law as described is reasonably clear, there is a lack of published guidance that is directly on point (except with respect to foreign government support provided to foreign charities), and that additional uncertainty has been caused by the guidance referenced above.

They also note that nothing in the statute or accompanying legislative history precludes treating support from Non-U.S. Public Organizations as unlimited. Following are among the primary policy arguments made by those with whom we spoke supporting this treatment:

- Support from domestic governmental entities and support from U.S. *per se* and publicly supported 509(a)(1) charities are considered unlimited. The same policy considerations apply with equal force to Non-U.S. Public Organizations (excluding support from foreign governments on the OFAC list of sanctioned countries).⁵⁰

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assumed far greater importance as international philanthropy has evolved during the past 40 years since enactment of the 1969 Act.

⁵⁰ As of the date of this writing, the OFAC list of sanctioned countries currently includes: the Balkans, Belarus, Burma, Ivory Coast, Cuba, Democratic Republic of the Congo, Iran, Iraq, the former Liberian Regime of Charles Taylor, North Korea, Sudan, Syria and Zimbabwe. Office of
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- Grants to Non-U.S. Public Organizations are not subject to the § 4945 expenditure responsibility rules under Treas. Reg. §§ 53.4945-5(a)(4) and (5). Because these organizations are treated as § 509(a)(1) organizations when they are **receiving** funds, the same logic suggests that they should be treated as § 509(a)(1) organizations when they are **providing** funds.
- Increasingly, U.S. and foreign charities involved in global philanthropy receive a meaningful portion of their support from Non-U.S. Public Organizations. Treating this support as limited for purposes of §§ 509(a)(1) and for purposes of § 4945 equivalency determinations could result in classifying the recipients as private foundations for U.S. purposes. In turn, this outcome (or risk of this outcome) would have several adverse effects. It would likely distort or undermine certain types of international philanthropic efforts, deter new organizations with these sources of support from organizing in the U.S. and marginalize the role of U.S.-based charities in important and evolving patterns of international philanthropy.
- More generally, treating as unlimited the support provided by Non-U.S. Public Organizations is consistent with important, non-tax international and diplomatic initiatives of the U.S. government.

Specific Recommendations. Based on the foregoing, our understanding is that the IRS will apply Rev. Rul. 75-435 as current law in issuing private letter rulings regarding equivalency determinations, including with respect to EDIR proposals, and in published guidance regarding EDIRs. To properly reflect its holding and analysis, the IRS should not read a same-country limitation into Rev. Rul. 74-435.

We recommend that the IRS confirm that it will apply the analysis of Rev. Rul. 75-435 to treat foreign government support as unlimited support for all purposes of § 509(a). For the reasons set forth above, we believe this is the right policy answer and is consistent with the holding and analysis in Rev. Rul. 75-435—a pronouncement that has now been on the books for 34 years.

We recommend that the IRS and Treasury provide guidance in a revenue ruling or through regulations that support from U.S. government-designated international organizations is treated as unlimited support for all purposes of § 509(a).

We further recommend that the IRS and Treasury provide guidance in a revenue ruling or regulations that for purposes of Treas. Reg. § 53.4945-5(a)(4) and Rev. Rul. 75-435 support from foreign governments on the OFAC list of sanctioned countries is not treated as unlimited support for purposes of § 509(a).

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Foreign Assets Control, *OFAC Country Sanctions Programs*,
www.ustreas.gov/offices/enforcement/ofac/programs (last visited May 5, 2009).

Recommendation 3: Expenditure Responsibility Reporting Requirements

We recommend that the IRS and Treasury simplify and enhance application of the expenditure responsibility requirements imposed by § 4945 by providing safe harbor reporting periods for grants of capital assets or used to acquire capital assets.

Background. A private foundation must exercise “expenditure responsibility” if it wishes to make a grant to a foreign organization that has not been determined to be equivalent to a U.S. public charity, is not a foreign government or instrumentality or agency thereof, and is not an international organization such as the United Nations, the World Health Organization, the Southeast Asia Treaty Organization, the International Monetary Fund, the International Labor Organization or the International Bank for Reconstruction and Development, designated by executive order pursuant to 22 U.S.C. § 288.⁵¹

The expenditure responsibility rules prescribe a detailed, multi-step process that the granting private foundation and the recipient grantee organization must complete over the course of the grant to ensure that the grant is not a prohibited taxable expenditure. In general, to exercise expenditure responsibility, a private foundation must exert all reasonable efforts and to establish adequate procedures (1) to see that the grant is spent solely for the purposes for which made, (2) to obtain full and complete reports from the grantee on how the funds are spent, and (3) to make full and detailed reports with respect to such expenditures to the IRS.⁵²

The regulations under § 4945(d) mandate a procedure by which a private foundation may conduct expenditure responsibility:

- *Pre-Grant Inquiry.* Prior to making the grant, the private foundation must conduct a “pre-grant inquiry” regarding the grant recipient and the anticipated use of the grant. This inquiry should be complete enough to provide reasonable assurance that the grantee will use the grant for the proper purposes. The granting foundation need not conduct a pre-grant inquiry if it has previous experience with a particular grantee and that grantee has properly used all prior grants and filed the required substantiating reports.⁵³
- *Grant Limitations.* The grant agreement must clearly specify the purposes of the grant, and, to account for differences between U.S. law and the law of the foreign jurisdiction, the agreement must impose restrictions on the use of the grant substantially equivalent to the limitations imposed on a U.S. private

⁵¹ Treas. Reg. § 53.4945-5(a).

⁵² § 4945(h).

⁵³ Treas. Reg. § 53.4945-5(b)(2).

foundation. To ensure that the agreement meets this requirement, the grantor or grantee must obtain an affidavit or opinion of counsel stating that the restrictions on the use of the grant under foreign law or custom are substantially equivalent to those imposed on a U.S. private foundation.⁵⁴

- *Grant Terms.* In addition, the grant agreement must provide that the grantee agrees to the following terms: (i) to repay any portion of the amount granted which is not used for the purposes of the grant; (ii) to submit full and complete annual reports on the manner in which the funds are spent and the progress made in accomplishing the purposes of the grant; (iii) to maintain records of receipts and expenditures and to make its books and records available to the grantor at reasonable times; and (iv) not to use any funds to influence legislation; to influence any specific public election or to carry on a voter registration drive; to make a grant to an individual for travel, study, or other similar purposes unless certain requirements are satisfied; or to undertake any activity for other than charitable purposes.⁵⁵
- *Segregated Account.* A foreign grantee organization that does not have a U.S. determination letter generally must hold grant funds in a segregated account dedicated exclusively for the charitable purposes unless the foundation manager can make a “reasonable judgment” that the foreign organization is described in § 501(c)(3).⁵⁶
- *Grantee Reporting—General.* Expenditure responsibility also requires extensive reporting from the grantee on the use of the grant funds. Specifically, the grantee must report on the use of the funds, compliance with the terms of the grant, and the progress made by the grantee toward achieving the purposes for which the grant was made.⁵⁷ The grantee generally must make such reports every year until the “grant funds are expended in full.” In addition, the grantee must make a final report with respect to all expenditures made from the grant funds (including salaries, travel, and supplies) and indicating the progress made toward the goals of the grant after the grant is completed. The grantor need not conduct any independent verification of such reports unless it has reason to doubt their accuracy or reliability.
- *Grantee Reporting—Capital Assets.* As noted above, grantees are required to report annually until the funds are expended in full. There is no guidance regarding the application of this requirement in the context of grants of capital assets or used to acquire capital assets. There are, however, special rules for reporting in connection with grants to private foundations for the purchase of

⁵⁴ Treas. Reg. §§ 53.4945-5(b)(3)-(5).

⁵⁵ Treas. Reg. § 53.4945-5(b)(3).

⁵⁶ Treas. Reg. § 53.4945-5(c).

⁵⁷ Treas. Reg. § 53.4945-5(c)(1).

capital equipment, for endowment, or for other capital purposes.⁵⁸ Under these rules, the grantor foundation may discontinue the requirement to obtain annual reports from the grantee foundation two years after the year in which the grant was made if it is “reasonably apparent” to the grantor foundation that neither the principal, the income, nor any equipment purchased with grant funds has been used for any purpose which would result in a taxable expenditure.

The exception only applies for grants to another private foundation—if the grantee is not a private foundation, the grantee must report for the life of the asset (and the foundation must provide reporting to the IRS as long as it is required to obtain reports from its grantee). Foreign organizations are not eligible for the exception to the grantee reporting requirements unless they have a determination letter that they are exempt from tax under § 501(a).

- *Grantor Reporting.* The grantor private foundation must provide information to the IRS regarding each grant requiring it to exercise expenditure responsibility when it files its annual Form 990-PF. The information must include: (i) the name and address of the grantee; (ii) the date and amount of the grant; (iii) the purpose of the grant; (iv) the amounts expended by the grantee (based upon the most recent report received from the grantee); (v) whether the grantee has diverted any portion of the funds (or the income from them in the case of an endowment grant) from the purpose of the grant (to the knowledge of the grantor); (vi) the dates of any reports received from the grantee; and (vii) the date and results of any required verification of the grantee’s reports.⁵⁹
- *Grantor Recordkeeping.* The grantor private foundation also must retain the following documents to provide to the IRS upon request: a copy of the grant agreement, copies of the grantor reports, and copies of reports made by the grantor’s personnel or independent auditors concerning any investigations made during the course of the grant.⁶⁰

Issues. There appears to be widespread recognition that the expenditure responsibility rules are potentially quite burdensome in many circumstances. For example, the legislative history to the Deficit Reduction Act of 1984 reflected congressional concern that the reporting requirements imposed on private foundations under Treas. Reg. § 53.4945-5(d) were too burdensome. The conference report accompanying the legislation explained the issue:

⁵⁸ Treas. Reg. § 53.4945-5(c)(2); *Charles Stewart Mott Foundation v. United States*, 938 F.2d 58 (6th Cir. 1991) (holding that a private foundation’s purchase of debentures from a community development corporation that was not a private foundation was a capital expenditure that was ineligible for the two-year reporting exception from the grantee and grantor reporting requirements).

⁵⁹ Treas. Reg. §§ 53.4945-5(d)(1)-(2).

⁶⁰ Treas. Reg. § 53.4945-5(d)(3).

The conference committee reaffirms the central purpose of the expenditure responsibility rules—to ensure that foundation grants will be properly used by the recipient organization solely for exempt purposes. At the same time, because the committee is concerned whether implementation of the statutory requirements in Treasury regulations may have added unduly burdensome or unnecessary requirements in some respects (which may operate to deter grants by some foundations to newly formed, community-based foundations), the conference agreement follows the approach under the House bill and the Senate amendment in directing the Treasury to review its expenditure responsibility regulations for purposes of modifying any requirements which are found to be unduly burdensome or unnecessary. As part of its review, the Treasury is to modify the required grantor reports to the IRS. The Treasury is to report to the tax-writing committees on its review and modifications.⁶¹

We have been unable to determine whether Treasury complied with this directive and, in any event, the relevant regulations have not been amended since issued in 1973 and to our knowledge, the IRS and Treasury have not issued any published guidance otherwise modifying or clarifying the rules.

During our review, the primary concern voiced by those dealing with the expenditure responsibility requirements was the lack of certainty in reporting periods applicable to grants of capital assets or for the acquisition of capital assets. Depending upon the particular circumstances, approaches used or considered by grantmakers and their advisors to establish reporting periods included, for example, the cost recovery period for financial (or tax) accounting purposes; the special two-year rule applicable to grants to private foundations; actual disposition through sale or abandonment of the asset; or, the point at which all funds are “expended” to acquire the asset.

⁶¹ H.R. Conf. Rep. No. 961, 98th Cong., 2d Sess., 1984 U.S.C.C.A.N. 1445, 1779. See also *Deficit Reduction Act of 1984—Private Foundation and Miscellaneous Provisions*, 12, 1985 EO CPE Text. (“Although no statutory change was made, the Conference Committee Report that accompanied H.R. 4170 directs the Treasury Department to review the expenditure responsibility requirements in the regulations underlying IRC 4945 to determine whether any of these requirements are unduly burdensome or unnecessary. As part of its review, the Treasury Department was specifically directed to modify the requirements for grantor reports to the IRS (Reg. 53.4945-5(d)). In requesting this review, Congress was concerned whether the existing regulations might operate to deter grants by some foundations to newly formed, community-based organizations. Until these modifications are made, the existing provisions of these regulations will remain in effect.”)

Three general observations emerged from our review. First, this uncertainty can deter or distort international grantmaking of capital assets or for the acquisition of capital assets. Second, as the focus of international philanthropy has shifted to issues such as the environment, health care and education, grants that provide or fund capital assets have become far more important, and the reporting requirements a far greater barrier to effective philanthropy. Following are examples of funding activities that can be impeded or distorted by the current rules: the installation of water purification systems and renewable energy equipment; the purchase and permanent dedication of land for environmental preservation; the acquisition of health care assets ranging from hospital beds to complex diagnostic equipment to mobile medical clinics; and funding for the construction of schools and the purchase of school supplies. Third, the rules can be especially harsh where funds expended for capital assets are small in absolute terms or relative to the overall focus of the grant (e.g., \$10,000 to purchase miscellaneous medical equipment for use in a hospital; a grant where the reasonable anticipation is that capital asset purchases will be less than five or ten percent of the entire grant amount).

Recommendation. We recommend that the IRS provide safe harbor reporting requirements for grants of or to purchase capital assets. Following is our suggested framework:

- Provide a “when expended” rule for capital assets whose use is inherently in furtherance of the intended charitable purpose. Examples in the environmental context include the installation of water purification systems and renewable energy equipment; medical equipment with limited non-medical use potential and the purchase and permanent dedication of land for environmental preservation. Consideration should be given to publishing a Rev. Proc. which contains a safe harbor list of such inherently charitable use assets.
- Provide a “when expended” rule for capital assets having relatively nominal cost expenditures.
- Provide a “when expended” rule for capital assets where the grantmaker reasonably expects that capital asset acquisitions will not exceed stated percentage of the total grant amount.

In situations where the first three approaches are not appropriate, provide one or more safe harbor periods for assets whose use is not inherently in furtherance of the intended charitable purpose and other assets not subject to the foregoing “when expended” rules. One approach would be to provide the same period for all capital assets (e.g., three years following the year the funds are expended). An alternative approach would be to provide several different reporting periods depending on the type of asset. For example, specified assets such as land and buildings could be subject to a longer reporting period (e.g., seven years).

Consistent with the purpose for the expenditure responsibility rules, the terms of grants of capital assets or funds used to purchase capital assets should require that grant recipients report to the grantmaker during any year in which the asset is used for a noncharitable purpose or is disposed of (in which case the grant recipient should report on the use of proceeds or other consideration received in exchange). The grantmaker would be required to report such information to the IRS for its taxable year in which such exception reporting occurs and take such circumstances into account in making any further grants to the recipient organization.

Recommendation 4: Program-Related Investments

We recommend that the IRS and Treasury update guidance under the program-related investment rules by providing additional examples of permitted program-related investments, focusing on international activities and using the 2002 recommendations from an informal working group made up of members of the PRI Task Force as a starting point.

Background. Private foundations sometimes engage in activities that are structured as investments, but that have a primary purpose other than the production of income. These are referred to as program-related investments (“PRIs”).

A PRI is an investment “the primary purpose of which is to accomplish one or more of [certain generally exempt-type] purposes . . . and no significant purpose of which is the production of income or the appreciation of property.”⁶² Permitted purposes include “religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.”⁶³ PRIs are not subject to the excess business holding rules of § 4943,⁶⁴ and may also be treated as “qualifying distributions” for purposes of the minimum distribution rules.⁶⁵ Moreover, if an investment qualifies as a PRI, it will not “be considered as [an] investment . . . which jeopardize[s] the carrying out of exempt purposes.”⁶⁶

⁶² § 4944(c).

⁶³ § 170(c)(2)(B).

⁶⁴ Treas. Reg. § 53.4943-10(b).

⁶⁵ Treas. Reg. § 53.4942(a)-3.

⁶⁶ § 4944(c).

The Issue. The regulations under § 4943 provide substantial detail about which investments qualify as PRIs.⁶⁷ In particular, the regulations rely on a series of examples to illustrate the relevant principles. However, these regulations date to 1972.⁶⁸ They do not explicitly address cross-border PRIs.⁶⁹ Moreover, the examples do not adequately reflect the evolution of PRIs over the last 35 years. David Chernoff, a prominent commentator and authority on private foundation grantmaking, refers to them as “stale.”⁷⁰ Chernoff, in a 2001 article, deplores the absence of examples in the PRI regulations regarding foreign activity, writing:

Today, there is considerably more grantmaking in foreign countries by U.S. charities than there was 30 years ago. One of the 11 projects on the Service’s guidance priority list for 2000 was guidance on private foundations’ assistance to foreign entities. That need continues.⁷¹

In 2002, the PRI Task Force convened on the subject submitted comments to the IRS proposing that the examples in the regulation should “be supplemented to reflect grantmaking philosophy and practices, international social and economic realities, and forms of doing business emerging in the 21st [c]entury.”⁷² The PRI Task Force proposed a series of new examples for the regulations that define PRIs.

The PRI Task Force’s suggested examples address a number of issues including several international ones. In fact, seven of the ten suggested examples pertain directly to the international context. The proposal asks the IRS to specify that “[i]f an activity is charitable when conducted in the U.S., it is likewise charitable when conducted in a foreign country.”⁷³ In addition, the proposed examples discuss several other points relating to cross-border investments. For instance, they would clarify that “[r]aising the living standards of needy families in underdeveloped or developing countries serves a charitable purpose,”⁷⁴ and that “[n]ot just the presence of a ‘significant’ financial return, but the presence of a seemingly high projected rate of return should not, by itself, prevent a foreign investment from qualifying as a program-related investment.”⁷⁵

⁶⁷ Treas. Reg. § 53.4944-3(b).

⁶⁸ Treas. Reg. § 53.4944-3.

⁶⁹ Treas. Reg. § 53.4944-3(b).

⁷⁰ David S. Chernoff, *Outdated Regulations Hamper Foundations Making Foreign Program-Related Investments*, 12 J. of Exempts 248 (May/June 2001).

⁷¹ *Id.*

⁷² Section on Taxation, American Bar Association, Draft Examples of Program-Related Investments (“PRIs”) (for addition to Treas. Reg. Sec. 4944-3(b)) and Analysis of Each 1 (2002).

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

Rationale for Recommendation. Based on our review, there is widespread agreement within the sector that the need to provide additional guidance under the PRI rules is even more pressing today than it was in the past. The IRS and Treasury should provide guidance that builds on the examples suggested by the examples proposed by the PRI Task Force. Providing additional guidance serves a compliance function. The PRI landscape has changed and will continue to evolve. By providing examples that reflect current practices, the IRS and Treasury can use the guidance as a way to help establish a useful framework for foundations and their advisors. While our focus is on international philanthropy, we believe the guidance should not be limited in that fashion because significant philanthropic innovations are also occurring domestically.

While the initial set of PRI examples was provided in the regulations, we recommend that the IRS issue additional guidance through one or more revenue rulings. The existing regulations and examples establish the basic guiding principles and we do not believe that they need to be modified. Rather, the examples proposed by the PRI Task Force are meant merely to clarify how those rules apply to new forms of PRIs. The virtue of the revenue ruling process, in addition to the fact that it is less resource-intensive, is that it provides the kind of flexibility that will be needed to respond to ongoing developments in the field.

Appendix A. Organizations and Individuals Consulted

Below is a list of organizations and individuals we have consulted. Not every organization or individual expressed views on every topic, nor did they express identical views on issues where they did voice an opinion. We have attempted to assemble and fairly reflect the views expressed, and take full responsibility for any errors or omissions. We also emphasize that we have not attempted to characterize or summarize the views of government representatives with whom we spoke regarding any aspect of our Report.

Organizations

Amnesty International USA, New York, NY

Church of Jesus Christ of the Latter-Day Saints, Salt Lake City, UT

Bill and Melinda Gates Foundation, Seattle, WA

GAVI Alliance, Geneva, Switzerland

William and Flora Hewlett Foundation, Menlo Park, CA

International Center for Not-for-Profit Law, Washington, DC

John D. and Catherine T. MacArthur Foundation, Chicago, IL

Rockefeller Brothers Fund, Inc., New York, NY

The Skoll Foundation, Palo Alto, CA

St. Jude Children's Research Hospital, Memphis, TN

Wheelchair Foundation, Danville, CA

Practitioners

Betsy Buchalter Adler, Adler & Colvin, San Francisco, CA

Jody Blazek, Blazek & Vetterling LLP, Houston, TX

Victoria B. Bjorklund, Simpson, Thacher & Bartlett, New York, NY

Michael W. Durham, Caplin & Drysdale, Washington, DC

John A. Edie, PricewaterhouseCoopers, Washington DC

Diara M. Holmes, Caplin & Drysdale, Washington, DC

Andras Kosaras, Arnold & Porter , Washington, DC

Douglas Mancino, McDermott, Will & Emery, Los Angeles, CA

Celia Roady, Morgan, Lewis & Bockius, Washington, DC

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Academics

Harvey P. Dale, New York University School of Law, New York, NY

Jill S. Manny, New York University School of Law, New York, NY

Christopher Stone, Kennedy School of Government, Harvard University,
Cambridge, MA

Governmental Officials

Tamara Ashford, Internal Revenue Service

David Fish, Internal Revenue Service

Karin Gross, Internal Revenue Service

Emily M. Lam, Department of the Treasury, Office of Tax Policy

Lois G. Lerner, Internal Revenue Service

Catherine E. Livingston, Internal Revenue Service

Theresa Pattara, U.S. Senate Committee on Finance

Ronald J. Schultz, Internal Revenue Service

Tiffany Smith, U.S. Senate Committee on Finance

Nancy Todd, Internal Revenue Service

Cindy Westcott, Internal Revenue Service

**ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)**

**INTERNATIONAL PENSION ISSUES
IN A GLOBAL ECONOMY:
A SURVEY AND ASSESSMENT OF IRS'
ROLE IN BREAKING DOWN THE BARRIERS**

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I. EXECUTIVE SUMMARY

A. Overview of Report

The focus of the Employee Plans subcommittee of the ACT for the year 2008-2009 was to survey and assess the most important federal tax issues affecting retirement plans of employers involved in cross-border transactions and the Internal Revenue Service ("IRS") Employee Plans Division's role in addressing those issues and providing education and outreach.

The ACT began their project by creating an inventory of international issues developed from the experiences of the ACT Employee Plans members along with an outline of the various aspects of retirement plans affected by a globalized workforce, spanning from federal tax compliance in plan design, to meeting coverage requirements, to tax reporting and withholding on retirement plan distributions.

During the year, the ACT met with or had telephone conference with representatives of the Treasury and IRS, including the Tax Exempt and Government Entities Division (TE/GE), and the Large and Mid-Size Business Division (LMSB), and IRS office located in other U.S. possessions, as well as several external stakeholders.

The results of the survey and assessment extend into areas not within the scope of TE/GE's jurisdiction; however, the ACT determined that inclusion was necessary to fully represent its findings.

It is the ACT's hope that this report will spur the IRS to begin to address these international pension issues as "one" IRS, while keeping in mind the goal...

...to break down the barriers and impediments to U.S. employers desiring to provide pensions to nonresident aliens working in the United States and to U.S. citizens and resident aliens transferred to affiliates of U.S. employers outside the United States.

B. Principles

In developing its recommendations, the ACT was guided by the following principles:

1. The ACT's due diligence process should solicit the views of the IRS, practitioners, and stakeholders who are confronted with international pension issues on a regular basis.
2. The ACT should determine the level of coordination between the IRS divisions and identify gaps in services in their efforts to address international pension issues for both employers and employees, including tax withholding and reporting by administrators of pension plans and

payers currently faced with distributions to nonresident aliens and expatriates.

3. The ACT should identify applicable law, regulations, treaty or other legal guidance that present impediments to providing international pensions and suggest proposed solutions or clarifications.
4. The recommendations of the ACT should include a component addressing the need for educating the pension community on the most common international pension issues faced by employers, employees, and the IRS.
5. Tools should be provided to assist the IRS in its education and outreach efforts on international pension issues.

C. Recommendations

The ACT's recommendations can be classified into three (3) categories as follows:

1. "One IRS" on International Pension Issues

a. Create an IRS "International Focus Team"

- Create an "International Focus Team" consisting of representatives of each of the IRS Divisions: TE/GE, LMSB, W&I, and SBSE, with the goal of addressing the issues raised in this report, as well as other issues identified by the Team, in part through education and outreach (see below).

b. Formalize an Internal Working Group for Treaty Negotiations

- Formalize an internal working group between Treasury, Chief Counsel, IRS TE/GE Employee Plans, and LMSB to address treaty issues and to provide input regarding treaty negotiations. Clarification is needed as to where jurisdiction resides with respect to treaty issues that impact multiple business units within IRS and Treasury. Some of the issues to be reconciled by this working group are included in this report.

2. Internal Revenue Code Issues

The IRS is requested to issue guidance or work with Treasury and other agencies to obtain guidance regarding retirement plan related international pension issues. This section also includes requests for new provisions and treaty-related guidance.

The categories and sections of the Internal Revenue Code ("Code")¹ for which guidance is requested include:

a. Pension Contributions and Benefits

- Code §§ 83, 404, and 404A with regard to how contribution deductions are allocated between U.S. and foreign employers since the Pension Protection Act of 2006².
- Code § 404 with regard to deductions by a U.S. employer for contributions made by a foreign affiliate with respect to foreign compensation includible under Code § 404.
- Code § 415 with regard to the inclusion of an employee's foreign compensation as compensation for purposes of employer nonelective contributions to a 403(b) plan.
- Code §§ 415 and 985 with regard to foreign exchange issues.
- Multiemployer Plans - Canada - enter negotiations to allow U.S. multiemployer contributions to follow a temporary U.S. worker back to Canada.
- The definition of "comparable plans" for treaty purposes and whether nonqualified wrap and restoration plans are included, perhaps using the Code § 409A definition of a "broad-based foreign retirement plan" for this purpose.
- The treatment of contributions and dividends to foreign trusts for U.S. tax purposes.
- The treatment of contributions to IRAs and rollovers under treaties.
- Taxation of U.S. citizens on accruals and earnings in other countries.
- Reconciliation of the timing of determinations regarding treaty coverage and the filing tax returns.
- The requirements for a Taxpayer Identification Number when no tax revenues are involved.
- The idea of and need for a Global Retirement Plan.

¹ References to the "Internal Revenue Code" and the "Code" are to the Internal Revenue Code of 1986, as amended.

² P.L. 109-28 (August 17, 2006).

b. Pension Distributions

- Code § 864 with regard to the determination of the portion of a pension distribution to a nonresident alien that constitutes ECI (income effectively connected with the United States).
- Code § 871(f) with regard to the need for an exclusion from nonresident alien income of lump sums on the same basis as the current exclusion for payment of annuities.
- Code § 402(f) with regard to inclusion in the Direct Rollover Notice of special rules for pension distributions to nonresident aliens.
- Evaluating the flat withholding rates (0%-30% rate) to determine if another rate or series of rates would more closely relate the rate to the actual taxed owed by the nonresident alien.
- The Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART Act")³ with respect to reporting issues for nonresident aliens, including clarification as to the types of plan distributions that will be subject to the new HEART Act tax on expatriates' deferred compensation and whether there are differences between the treatment of distributions from qualified retirement plans, non-qualified plans and IRAs.
- Guidance to address the coding and other issues related to reporting nonresident alien distributions from qualified retirement plans and IRAs on IRS Form 1042-S with input from the IRS Information Reporting Program Advisory Counsel ("IRPAC").
- ERISA⁴ 1022(i) plans covering Puerto Rico residents with regard to the transition rules on rollovers, investment of plan assets, and coverage issues.
- Asset pooling issues under Revenue Ruling 81-100 regarding participation by Puerto Rico-only qualified plans in U.S. group trusts.
- Special issues for Guam and Mariana Islands plans with regard to withholding and reporting of pension distributions, investment by a Guam plan in U.S. stocks, and estate taxes relating to pension plans or IRAs with U.S. assets.

³ P.L. 110-245, 122 Stat. 1624 (June 17, 2008).

⁴ Employee Retirement Income Security Act of 1974, P.L. 93-406, 88 Stat. 829 (September 2, 1974).

- Allow rollovers to U.S. plans and IRAs of eligible distributions from approved “broad-based foreign retirement plans” meeting the Code § 409A definition.
- Multiple spouses for purposes of meeting spousal consent and other spouse benefit rights.

c. Non-qualified Deferred Compensation

- Code § 402(b)(4) with regard to taxation of foreign deferred compensation plans.

3. Education and Outreach on International Pension Issues

Provide education and outreach to employers and payers with regard to rules for taxation and rollovers of pension distributions to nonresident aliens and U.S. citizens working abroad. The recommendations include:

a. Revised and New IRS Publications

- Revising and updating specific existing IRS Publications to correct or add needed information on international pension issues.
- Using the sample tools provided in Exhibits to this report as the basis for creating new publications on international pension issues, which include the following:
 - (i) FAQs (frequently asked questions with answers) covering certain pension tax matters involving U.S. possessions;
 - (ii) A summary of the reporting and withholding rules applicable to pension and IRA distributions to non-resident aliens; and
 - (iii) A Primer on international pension rules that could be issued by the IRS as a single publication or in a series of newsletters or articles distributed to taxpayers, plan sponsors and payers, and posted on the international pensions website (see below).

b. IRS Website Improvements

- Establishing a dedicated IRS website to international pension issues that contains information from all IRS Divisions.
- Assigning a dedicated IRS email address for questions and comments about international pension issues.

- Adding a link to this Report with a request for input from the public for more information about the issues facing employers, payers, and taxpayers and recommendations for guidance or change.
- Include links to all international pension publications, including those listed in Exhibit A to this report.

c. Expanded IRS Seminars

- Coordination between the IRS Divisions, especially TE/GE, LMSB, and W&I, to give joint presentations at tax conferences and in other public forums on reporting and withholding on pension distributions.

II. INTRODUCTION

A. Today's World – The Global Workplace

The financial events of the past year have provided a vivid reminder of how globally connected our marketplace has become. In the employee benefits area, the increasing globalization of U.S. business operations has resulted in the cross-border transfer of employees as U.S. companies strive to ensure that the necessary talent and expertise is in place wherever they do business. These cross-border transfers necessarily impact employee benefits and deferred compensation of all types—pension, welfare, and fringe benefits, as well as stock-based and deferred compensation plans and programs.

In April 2008, IRS Commissioner Douglas Shulman addressed the Tax Executives Institute meeting in Washington, DC, about “the challenges of tax administration in a global economy.” Noting that it “is an area where there are a number of vexing issues without easy answers,” he asked for cooperation from practitioners and experts to work with the IRS to provide these answers.

In remarks presented to the Tax Analysts Conference in 2008 on the IRS Restructuring and Reform Act of 1998 (the “Restructuring and Reform Act”)⁵, Commissioner Shulman discussed the impact of international tax issues on the restructured IRS⁶, noting that while the current IRS structure focuses on taxpayer (or customer) segments, issues involving global workforces cross IRS Division lines and require inter-Division coordination. Given this fact, Commissioner Shulman said, “I believe we need to reinforce the notion of ‘One IRS.’” This idea of “One IRS” is particularly necessary when dealing with international pension issues.

To support Commissioner Shulman’s objectives, Steven T. Miller, Commissioner of the Tax-Exempt and Government Entities Division (TE/GE), communicated to his Directors the need for an “International Environmental Scan,” with the long-term objective of “developing a solid understanding of the most important federal tax administration issues implicated by the intersection between the globalization movement and our communities and customers, including . . . employee plans . . . in order to align TE/GE’s service and enforcement efforts with the Servicewide approach to international tax administration.” Mr. Miller added a short-term task of “working with external stakeholders to conduct an environmental scan of . . . employee plans and their sponsors regarding these plans, . . . regarding [international] [cross-border] activities and issues.” The ACT was identified as one of the external stakeholders asked to participate in this environmental scan.

⁵ IRS Newswire, IR-2008-090 (July 18, 2008).

⁶ As a result of restructuring under the Restructuring and Reform Act, the four primary divisions of the IRS are Wage and Investment (W&I), Large and Mid-Size Business (LMSB), Small Business/Self-Employed (SBSE) and Tax-Exempt and Government Entities (TE/GE).

B. Concerns and Challenges

Employees, whether U.S. citizens transferred to work abroad or foreign nationals assigned to work in the United States, naturally are concerned about the impact of their home country's tax rules and those of the country of relocation on their compensation and benefits.

Employers engaging in cross-border employee transfers must consider which benefit plans will cover transferred employees, as well as the impact their participation will have on the tax qualification of those plans. Employers also need to understand the tax impact on the transferred workers to determine whether reimbursements or other compensation is desirable to compensate the transferred employee for any lost tax advantages or adverse tax consequences.

In carrying out their respective analyses of the corporate and benefit aspects of cross-border employment transfers, employees and employers face a bewildering array of issues involving U.S. and foreign tax and benefit law, including the added layer of complexity presented by tax treaty issues if the employment transfer involves work in countries with which the United States has entered into such a treaty.

In these difficult economic times, it should be noted that the burdens of compliance with increasingly complex requirements of the Internal Revenue Code (the "Code") and regulations with respect to U.S. taxpayers' participation in foreign compensation arrangements when working abroad (e.g., §§ 409A and 457A) may provide an impetus for U.S. and especially foreign employers to hire non-U.S. employees to fill jobs at all levels of the organization.

The globalization of businesses and workforces makes this topic of "international benefits" a timely one and of significant concern for the IRS in its efforts to encourage tax compliance by employees and employers and to support employers in their efforts to provide tax-favored benefits and properly report taxable distributions from qualified retirement plans to nonresident aliens and expatriates.

Recent surveys of multinational employers consistently indicated that a vast majority of multinational employers depend on a decentralized approach to benefit plan design and tax compliance. That is, most are compelled to allow local managers and consultants to have oversight of their local populations' benefit programs. The primary reason given for this decentralized practice is due to concerns about company headquarters' inability to stay in compliance with laws and regulations in foreign labor markets. Consequently, less than 25% of surveyed multinational employers indicated that they have a global benefits manager who oversees all of their foreign and domestic employee benefit plans.⁷

Most multinational companies provide their expatriate employees with employee benefit programs, according to a 2005 survey by Mercer Human Resources

⁷ *Global Benefits Strategies Survey* (ASINTA, November 2003, at 10).

Consulting. The survey found that 75% of the respondents had policies in place to offer employee benefits to employees posted overseas, while the remaining 25% either did not offer employee benefits to expatriates or did offer benefits on an ad hoc basis. Only 23% of respondents to the survey maintain an international retirement plan (*i.e.*, a retirement plan exclusively designed for globally mobile employees and financed via a trust or insurance contract in an offshore tax-sheltered organization). “That figure is low because, according to the survey, respondents said it is typically expensive to administer such plans and challenging for the companies to comply with many different international regulations.”⁸

C. Purpose and Structure of Report

Unlike other areas of tax and benefit law, there is no “ready resource” to which employers and employees can turn in order to work through international pension and benefit issues. Indeed, practitioners with expertise in this area are few and far between. The report identifies the gap in services provided to employers on international tax matters and suggests ways to address certain problems generated by the failure of the Code to recognize, in some areas, the global activities of U.S. businesses.

This report represents what might best be called a “survey of international pension issues.” The focus is thus on issue identification. Although recommendations are made for the potential resolution of some issues, these recommendations have not been fully vetted with Treasury and IRS personnel or with international pension stakeholders. The ACT believes that such vetting must and no doubt will occur. With that caveat, however, it is anticipated that this report will provide a useful starting point for establishing priorities about the issues presented and the ultimate resolution of these issues.

The report identifies issues that are global in nature (*i.e.*, those common to international pensions generally), issues that are specific to U.S. territories and possessions, and issues applicable to certain specific countries.

As the ACT met with representatives from various interested parties, the dramatic lack of resources available to U.S. and foreign employers and workers regarding international pension issues became apparent. Therefore, the report concludes with a discussion and recommendations regarding education and outreach opportunities to make meaningful information accessible to stakeholders to assist them in their international pension planning and compliance.

It is also important to consider what this report does not do. It does not purport to cover every potential international pension issue. It does not cover important pension issues that fall under the jurisdiction of other federal agencies (*e.g.*, the U.S. Department of Labor). It does not focus on certain compensation and benefit issues that do not fall within TE/GE’s jurisdiction (*e.g.*, international issues involving

⁸ Barbara Cockburn, *Mercer survey examines expatriate benefits*, <http://www.businessinsurance.com/cgi-bin/news.pl?newsId=6906> (December 2005).

employer stock option programs). The international pension community is encouraged to respond with suggestions for topics and issues not identified in the report that TE/GE should also consider.

The report includes some issues that require legislative rather than regulatory resolution. While the ACT recognizes that the IRS cannot take independent action with respect to such issues, it is important that the issues be identified to provide Commissioner Shulman and others with as complete a picture as possible of the challenges facing U.S. companies operating in today's global business environment. This will enable Treasury to educate Congress about international pension problems over which the IRS does not currently have regulatory or enforcement jurisdiction.

The ACT has spent the last year gathering information to prepare this report. It is intended to provide a framework and foundation for TE/GE, in concert with the other IRS Divisions, to begin to address international pension issues for the benefit of employers and individuals, in furtherance of Commissioner Shulman's laudable goal to become "One IRS" and to break down the barriers to providing benefits in this global economy.

III. BACKGROUND

A. Overview

What was most striking in the preparation of the report has been the difficulty in finding one IRS resource that could provide the information sought by the ACT. The ACT learned that while there are significant IRS resources and efforts focused on assistance and guidance for individual taxpayer employees as to compensation and wages earned abroad and for nonresident aliens working in the United States, little attention has been paid to providing resources for the employers of these individuals particularly in regard to the retirement plans maintained by U.S. and foreign employers on their behalf. What follows in this Part of the report is an overview of the efforts IRS has made on international pension issues, and some general information about the U.S. taxation of worldwide income and the federal income tax withholding rules for pension distributions to nonresident aliens. This background information provides a frame of reference for what follows in this report.

B. IRS Efforts on International Pension Issues

Some of the projects undertaken and guidance provided by the IRS in connection with international pensions is listed below. It is by no means an exhaustive list, but it recognizes some areas of focus by the IRS.

1. Employee Plans Exams International Focus Team

This team was formed to enhance compliance through audits and outreach in Puerto Rico and other U.S. possessions.

One initiative of the team is the “Hacienda Project”, an effort to coordinate between the IRS and the Hacienda (formally the “Departamento de Hacienda” - Puerto Rico’s equivalent of the IRS). Among the team’s goals are to facilitate cross-referrals, help the Hacienda create a voluntary correction program similar to EPCRS⁹ for Puerto Rico-only qualified plans and provide audit training for dual-qualified plans (plans qualified in both the United States and Puerto Rico). The team has already conducted some audits and training has been provided for IRS agents on dual-qualified plans with a view towards training Hacienda agents on both dual-qualified and Puerto Rico—only qualified plans. A Memorandum of Understanding between the IRS and the Hacienda was signed in August 2006 and provides the basis for information sharing between the two agencies.

Cases for audit have also been chosen in the U.S. Virgin Islands, and audits will begin once a Memorandum of Understanding has been entered into with

⁹ EPCRS is the Employee Plans Compliance Resolution System; See IRS Revenue Procedure 2008-50, 2008-35 I.R.B. 464 (September 2, 2008).

the U.S. Virgin Islands Bureau of Internal Revenue that will clarify IRS jurisdiction and disclosure procedures between the two tax authorities.

Audits in other U.S. territories are anticipated.

2. The U.S. Model Income Tax Convention and Treaty Efforts

The Model Income Tax Convention of November 15, 2006, provides a template for bilateral treaty negotiations between the U.S. government and other nations for the purpose of avoiding double taxation and preventing fiscal evasion with respect to taxes on income. Based on information provided to the ACT, there are 59 U.S. income tax treaties in force covering 67 countries (the difference caused by the treaty with the USSR which still covers former members of the Soviet Union that have not entered into new treaties with the United States).

The IRS Office of Associate Counsel, International, interprets treaties and is responsible for cross-border pension plans. Treasury negotiates treaties but the negotiating team typically includes two IRS representatives, one from IRS Chief Counsel's office and one from the IRS competent authority's office. Treaty negotiations are ongoing and it can take years to finalize a treaty. See the discussion of treaty issues in Part V of this report.

3. IRS Website Information

Using the search terms "IRS Publications International" on the IRS website (www.irs.gov) produces a list of publications and information that currently exists for taxpayers on international tax matters. Exhibit A attached to this report lists some of the materials identified by this search.

4. IRS Large and Mid-Size Business Division (LMSB)

Kathy Robbins, Field Operations Director for LMSB, spoke at the October 17, 2008, Executive Enterprise Institute conference in Arlington, Virginia. Ms. Robbins discussed information reporting and the significant increase in cases concerning international issues. The IRS is reviewing information reporting issues with respect to IRS Form W-8 in recognition of the different terminology used by foreign companies. In addition, the IRS is increasing training and efforts to modernize its information reporting systems to better obtain and utilize information involving cross-border transactions and international businesses. LMSB provides a number of links on its website (www.irs.gov/businesses/international) to general tax information for international businesses, some of which are also referenced on Exhibit A of this report.

The ACT understands that a Servicewide International Planning & Operations Council was established in 2007 by the Deputy Commissioner, International (LMSB) with representation from each of the IRS business units. The primary focus of the Council has been preparing a Servicewide Budget Proposal for FY2010, preparing annual Priorities for the Servicewide Approach to Tax Administration, monitoring planned activities in support of the Servicewide Approach, and coordinating collaboration among business units to improve customer service and enforcement efforts.

There are currently five locations around the world where U.S. citizens (including expatriates) are being serviced - London, Paris, Frankfurt, Beijing and Florida (which services the Caribbean and South America). The IRS is currently considering what guidance is needed with respect to these U.S. citizens living outside of the United States and certain nonresidents. The following topics have been identified for review:

- Income reporting;
- Filing requirements;
- “Accidental Americans” – i.e., those born in the United States but who moved abroad when very young and are unaware of dual citizenship and U.S. tax filing requirements; and
- The need for coordination on international tax issues among the IRS business units.

To improve taxpayer service and achieve the overall IRS objectives, the senior IRS officials (called Tax Attaches) serving in these overseas locations maintain relationships and coordinate with the IRS business units, Treasury, Treaty partners, taxpayers, business organizations and the practitioner community. In addition, the overseas posts promote the IRS presence to address the need to encourage and facilitate voluntary compliance of a growing U.S. population overseas and a growing nonresident alien population with U.S. tax obligations.

In 2004, LMSB established a Voluntary Compliance Program (VCP) for payers who did not withhold and/or report taxes correctly under Code § 1441 with respect to distributions to nonresident and resident aliens.¹⁰

The LMSB International Compliance Strategy and Policy unit has announced that it will be focusing on ensuring compliance by U.S. withholding agents. LMSB has assumed that large employers hire tax professionals and consultants to assist with their international tax reporting and withholding issues.

¹⁰ Section 1441 Voluntary Compliance Program (the “Section 1441 VCP”), Rev. Proc. 2004-59, 2004-42 I.R.B. 678, effective September 29, 2004, until December 31, 2005, (later extended to March 31, 2006, by Rev. Proc. 2005-71, 2005-2 C.B. 985).

5. IRS Wage & Investment Division (W&I)

The W&I Division is charged with answering international tax law questions about reporting and withholding. A survey is being conducted of the expatriate community to determine how they obtain information and what taxpayer services they require. Although customer service representatives are directing taxpayers to the IRS website (www.irs.gov) and to its "frequently asked questions" (FAQs) pages for information, it appears that in some regions, such as the Middle East, Africa and parts of Asia, certain taxpayers may have difficulty accessing the Internet.

C. U.S. Taxation of Worldwide Income

Unlike most foreign jurisdictions that impose tax only on residents, U.S. federal income tax law imposes taxes under Code §§ 1 and 61 on U.S. citizens, permanent resident aliens (individuals holding a green card) and certain other resident aliens (individuals who meet the substantial presence test under Code § 7701(b)(1)(A)(ii)). Some foreign jurisdictions tax their residents only on domestic sourced income and not on income earned off-shore. The United States taxes citizens and resident aliens both on their U.S. source income and their off-shore or worldwide income ("U.S. Persons"). Although the Code provides tax credits to taxpayers who pay taxes to foreign jurisdictions¹¹ and certain exclusions for U.S. Persons working abroad¹², a U.S. Person must recognize a larger percentage of gross income than might be included by a non-U.S. Person who earns the same salary, but whose employer provides an off-shore trust to fund bonus or equity compensation. For U.S. Persons working abroad or for foreign persons working in the United States, treaties preventing double taxation offer some relief.

D. Federal Income Tax Withholding Rules on Pension Distributions to Nonresident Aliens

On October 6, 1997, the IRS issued final regulations under Code §1441, which deal with income tax withholding on certain payments of U.S. source income delivered outside of the United States to non-U.S. Persons, generally referred to as nonresident aliens.

A nonresident alien is an individual who is neither a U.S. citizen or resident nor a resident alien. IRS Publication 519 provides more information on resident and nonresident alien status, the tests for residence, and the exceptions to them.

The Code § 1441 regulations became effective generally with respect to payments made on or after January 1, 2000.¹³ These regulations have caused significant confusion because pension and IRA distribution withholding is generally governed under Code § 3405.

¹¹ Code §§ 901-906.

¹² Code § 911.

¹³ IRS Notice 98-16, 1998-15, I.R.B. 12 (April 13, 1998).

Distributions from a U.S. retirement plan to a nonresident alien outside of the United States may be subject to higher income tax withholding at the rate of 30% under Code § 1441, instead of the normal withholding rates described under Code § 3405. In the case of an IRA distribution, the rate would be 10%. For qualified retirement plans and 403(b) plans, the rate depends upon whether the distribution is periodic or nonperiodic.

For additional details, see Exhibit B of this Report (Summary of General Rules for Federal Income Tax Withholding and Reporting on Distributions from Qualified Pension Plans and IRAs to Nonresident Aliens).

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IV. DUE DILIGENCE PROCESS

A. Information Gathering

As part of the ACT's information gathering process for this report, the members interviewed various IRS and Treasury officials, along with international benefits practitioners and consultants. The ACT wishes to thank all of these individuals who generously gave of their time to the ACT for their valuable contributions to this report. Attached, as Exhibit C, is a list of the individuals who provided input for this report.

A survey prepared by the ACT was posted on BenefitsLink, www.benefitslink.com, which is an informational website for employee benefit professionals. A copy of the survey is attached as Exhibit D. The survey yielded very limited results - only one person formally responded to it.

The ACT would particularly like to thank representatives of the American Benefits Council (ABC) who provided valuable input for the report. The ABC is an advocate for employer-sponsored benefit programs. Its membership consists of companies, many of whose business focus is global. Discussions centered on impediments to doing business globally with respect to retirement benefits. The following issues, among others, emerged from these discussions:

- Deduction issues related to coverage of employees working abroad in U.S. plans;
- Administering "orphan" plans of U.S. affiliates;
- Dealing with tax issues related to foreign citizens working in the United States;
- Coverage issues presented by foreign affiliates;
- The need for a "multinational" plan for a company's foreign workers;
- The need for clear guidance on reporting and withholding rules;
- Lack of knowledge by foreign employers that certain programs are subject to U.S. laws (e.g., Code § 409A); and
- Problems identifying U.S. citizen-employees of acquired foreign companies.

B. Observations Gleaned from the Information Gathering Process

The following observations emerged from the ACT's information gathering process:

- There are many IRS rules with which even skilled practitioners are not familiar concerning retirement plans that cover employees in a global workforce.

- Corporations utilizing foreign national workers often do not know where these individuals are employed, hindering determinations of which country's tax and benefit rules apply.
- Foreign parents and subsidiaries of U.S.-based companies are reluctant to and, in some jurisdictions, by law cannot share information with their U.S. affiliates, especially with regard to compensation paid to and benefits provided for employees employed outside of the United States (in many instances due to local data privacy laws).
- Human resource and tax departments of U.S. companies often do not know that a U.S. citizen is working outside of the United States as a result of (i) a special assignment (secondment) by management; some of which are temporary or short-term, while others may be more permanent assignments or (ii) due to local hires of U.S. Persons where the local employer does not request or maintain information on employee's citizenship, residency or tax status.
- Within the IRS, various teams have emerged to work on international pension issues, but there is no formal coordination among the teams or within the IRS business units.
- Tax withholding and reporting errors occur due to the complexity of the applicable rules, not only with respect to the applicable withholding rate, but also with respect to the allocation of distributions among U.S. and foreign companies and the determination of where to send withheld taxes. Double taxation concerns also exist.
- Plans that are dual-qualified in the U.S. and Puerto Rico provide additional complications by having to comply with two sets of qualified plan rules and ERISA. Puerto Rico-only qualified plans are also subject to many provisions of ERISA.
- U.S. businesses that discontinue foreign operations want to administer orphan plans in the U.S. without impacting their other U.S. qualified plans.
- There is an increasing need for multinational pension plans providing greater mobility and portability.
- Foreign employers that cover U.S. Persons in their pension plans, especially under nonqualified deferred compensation arrangements, are often unaware that they may have reporting and withholding requirements due to their plans being subject to Code § 409A.
- Foreign employers acquiring other foreign employers often do not know that the presence of U.S. Persons in their workforce could subject the foreign employer to U.S. tax requirements.

V. SURVEY OF INTERNATIONAL PENSION ISSUES AND RECOMMENDATIONS

A. Overview and Global Recommendation

This section of the report discusses a variety of issues and provides recommendations concerning international pension matters. It is organized by topic and identifies the agency or division that would have primary responsibility for the implementation of the recommendations. While the ACT was asked to prioritize the recommendations and identify whether the recommendations involved an issue within or outside the United States, there was no consensus on the priorities due to the varied interests of the different stakeholders and the issues could not be easily categorized that way. Furthermore, the priorities may be more appropriately based upon IRS resources to effect the changes requested and should be determined in conjunction with future discussions with stakeholders.¹⁴

Successful implementation of the recommendations will depend in large part upon whether there is a commitment to ensure that TE/GE – Employee Plans not only is involved, but is a proactive participant in a coordinated effort among the various business units within IRS and Treasury in the implementation process. As with other coordinated efforts, a joint understanding of the process and formalization of the procedures for developing and implementing solutions to these international pension tax matters is essential.

B. Pension Contributions and Benefits

1. Deduction for Certain Foreign Deferred Compensation Plans Under Code § 404A Responsibility – IRS Counsel and Treasury

Background

A number of issues have arisen under Code §§ 83 (Property Transferred in Connection with Performance of Services), 404 (Deduction for Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation under a Deferred-Payment Plan), and 404A (Deduction for Certain Foreign Deferred Compensation Plans)¹⁵ after the Pension Protection Act of 2006

¹⁴ In addition, the ACT members have relied on input from TE/GE in identifying the primary responsible parties and acknowledges that the IRS Commissioner may wish to consider a different assignment of responsibility in responding to this report and implementing the recommendations.

¹⁵ While the ACT has not addressed other issues under Code § 404A, it learned that proposed regulations § 1.671-1(g) and (h) and § 1.671-2, which were published in the Federal Register on September 27, 1996, and address the application of the grantor trust rules to nonexempt employees' trusts in response to questions that arose in connection with Code § 404A regulations proposed in 1993, cannot be finalized until the grantor trust issues are resolved. It should be a priority to commit the resources from the various business units to finalize these regulations.

and FASB's Interpretation No. 48 (FIN 48).¹⁶ There are no clear rules for allocating deductions as there are under the sourcing rules for inclusion of income.

Issues

The issues are best illustrated by the following example.

An executive accrues a pension under a U.K. parent's plan while working for 3 years in the United States for a U.S. subsidiary of the U.K. parent, is transferred to Switzerland where he works for a number of years for a Swiss subsidiary of the U.K. parent, and later receives a distribution from the U.K. parent's pension plan. The sourcing rules provide guidance on how much the executive should include as income for U.S. federal income taxes. Although the U.S. subsidiary should be able to take a deduction for the contributions made on behalf of the executive while he worked in the United States, it is unclear whether the entire deduction can be allocated to the United States subsidiary or whether some proration is required.

Recommendation

Treasury should issue guidance under Code §§ 83, 404, and 404A on how deductions are allocated between U.S. and foreign employers.

2. Deduction Under Code § 404 for Contributions for Nonresident Aliens Allowed Based on Foreign Compensation under Code § 415

Responsibility – IRS TE/GE and Counsel, Treasury, and Congress

Background

As mentioned above, the LMSB is providing services to U.S. Persons in five locations around the world and intends to provide guidance on a number of issues. However, there does not appear to be recognition that employers in these locations also need guidance on how to report U.S. taxable income and under what circumstances a deduction is available.

Recently published Treas. Reg. § 1.415(c)-2(g)(5)(ii)¹⁷ allows a plan to exclude foreign compensation (i.e., compensation for services performed outside of the United States) for Code § 415 purposes if (1) it is paid to nonresident aliens working outside the United States who do not participate in the plan, and (2) the foreign compensation exclusion applies on a uniform

¹⁶ Financial Accounting Standards Board (FASB) Interpretation No. 48 *Accounting for Uncertainty in Income Taxes- an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes* (SFAS 109). This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

¹⁷ 72 Fed. Reg. 16878, 16918-16919 (April 5, 2007).

basis to all nonresident aliens. The preamble to the regulations indicates that this foreign compensation exclusion is relevant in determining who is a highly compensated employee under Code § 414(q)¹⁸ or a key employee for top-heavy purposes under Code § 416.

Treasury Regulation § 1.415(c)-2(g)(5)(i) clarifies that foreign compensation paid to a worker, including a nonresident alien, can be included as compensation for Code § 415 purposes, even though the foreign compensation is not included in the worker's U.S. gross income on account of the location of the services or on account of Code §§ 872, 893, 894, 911 and 933. According to the preamble¹⁹ to the regulations, the foreign compensation clarification means nonresident aliens working outside of the United States are not prevented from participating in a U.S. qualified plan on account of the Code § 415 compensation rules.

Issues

While the Code § 415 regulations generally accommodate foreign compensation for most tax-qualified plans, they do not authorize salary reduction contributions for purposes of Code §§ 401(k) or 403(b) by the foreign employer.²⁰ Thus, a 401(k) or 403(b) plan sponsor would have to make contributions on behalf of the U.S. citizens, resident aliens or nonresident aliens working for a foreign employer. However, the preamble to the Code § 415 regulations explains that the regulations do not modify the rules relating to the entity that is properly entitled to a deduction for contributions made to the plan on account of an employee's participation.²¹ The preamble appears to be referring to the general rule that an employer cannot deduct compensation paid on behalf of an employee of another employer, even if both employers are members of the same controlled group.²²

Recommendations

Treasury should recommend that Code § 404 be amended to allow a U.S. employer to deduct contributions to its U.S. qualified plans made on behalf

¹⁸ Code § 414(q)(8) states that nonresident aliens working outside the United States are not treated as employees.

¹⁹ 72 Fed. Reg. 16878, 16899 (April 5, 2007).

²⁰ The current Code § 415 regulations effectively prevent nonresident aliens working in the United States from participating in a 403(b) plan. However, nonresident aliens working outside the United States can participate in 403(b) plans, although salary reduction contributions by these nonresident aliens remain problematic because the home country may not recognize or may penalize the deferred compensation. Also, see discussion in paragraph 3 below.

²¹ A deduction will not be an issue for tax-exempt employers contributing to a 403(b) plan.

²² See *Transamerica Corp. v. United States*, 187 Ct. Cl. 119 (1984) (parent corporation could not deduct stock option compensation paid to an employee of its subsidiary); *Young & Rubicam, Inc. v. U.S.*, 187 Ct. Cl. 635 (1969) (employer could not deduct salaries and other related compensation, such as profit sharing plan contributions, paid for workers temporarily transferred to its foreign subsidiaries). Code §§ 406 and 407 provide limited exceptions to the general rule.

of participating U.S. citizens, resident aliens or nonresident aliens working for a foreign employer which is a member of the same controlled group of trades or businesses.

3. Foreign Compensation under Code § 415 for Purposes of 403(b) Plan Participation

Responsibility – IRS TE/GE and Counsel, Treasury, and Congress

Background

A 403(b) plan can cover nonresident aliens. In some cases these individuals may have no taxable compensation in the United States because of treaty provisions. In some cases the employee will make a treaty election by filing a W-8BEN, but in others the employee will make the election by filing for a refund of U.S. taxes with IRS Form 1040 which makes it difficult for an employer to know if the individual has taxable U.S. compensation.

Code § 415(c)(3)(E) limits a participant's compensation under a 403(b) program to the participant's "includible compensation" under Code § 403(b)(3).²³

Issues

While Treasury Regulation § 1.415(c)-2(g)(5) appears to provide for a broad inclusion of foreign compensation for 401(a) and 401(k) plans, § 1.415(c)-2(g)(1) provides that the inclusion provisions do not apply to 403(b) plans. The result is that nonresident aliens working in the U.S. are ineligible for both elective and non-elective contributions under a 403(b) plan. While not being permitted to make pre-tax deferrals from foreign compensation that is not taxed in the United States is not a problem, the provision does put the employer in the position of having to create a 401(k) plan in order to provide employer contributions for nonresident aliens, which seems to be a form over substance requirement.

Recommendations

Amend the Code § 415 regulations to provide that foreign compensation can be considered for purposes of nonelective contributions to a 403(b) plan. To the extent that this change is determined not to be within the regulatory authority of the Treasury Department, Treasury should recommend that Code § 403(b) be amended as necessary to provide the parity between 403(b) plans and 401(k) plans that was intended by the elimination of the exclusion allowance in favor of the 415 restrictions.

²³ Code § 403(b)(3); Treas. Reg. § 1.415(c)-2(g)(1).

4. Foreign Exchange Issues

Responsibility – IRS TE/GE and Counsel, and Treasury

Background

Plan participants are often paid in whole or in part in foreign currencies. Plan benefit formulae and contributions are typically determined in U.S. dollars.

Issues

If a U.S. Person working for an employer in a foreign country is paid in that country's currency, the timing of conversion of the compensation to U.S. dollars is an issue under the plan and under Code § 415. The current Code § 415 regulations do not address currency conversion.

As a practical matter, the plan document should provide that the currency conversion will be as of a specified date during the year in which the compensation is earned (e.g., December 31), not when contributions are made to a defined contribution plan or when pensions are calculated under a defined benefit plan. The issue is whether such a practical plan provision would comply with Code § 985,²⁴ which defines “functional currency” and specifies conversion rules for transactions conducted in a foreign currency.

According to IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*,²⁵ the following rules generally apply (emphasis added):

Your functional currency generally is the U.S. dollar unless you are required to use the currency of a foreign country. . . . The U.S. dollar is the functional currency for all taxpayers except some qualified business units.

If your functional currency is the U.S. dollar, you must immediately translate into dollars all items of income, expense, etc. (including taxes), that you receive, pay, or accrue in a foreign currency and that will affect computation of your income tax. Use the exchange rate prevailing when you receive, pay, or accrue the item. . .

If your functional currency is not the U.S. dollar, make all income tax determinations in your functional currency. At the end of the year, translate the results, such as income or loss, into U.S. dollars to report on your income tax return.

²⁴ Code § 985 and the related Code §§ 986-989 were enacted by § 1261(a) of the Tax Reform Act of 1986, Pub. L. No. 99-514.

²⁵ IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad* (November 2008) at 5, available at <http://www.irs.gov/publications/p54>.

[Emphasis Added].

While IRS Publication 54 is directed at individuals, not plan sponsors, Treasury Regulations for employers funding foreign plans rely on Code § 985.²⁶

Recommendations

The regulations under Code § 415 or Code § 985 need to include guidance regarding foreign currency provisions of U.S. qualified plans and reference the other Code sections to which the currency conversion rules apply. The guidance to employer/plan sponsors should be consistent with the guidance to individual taxpayers provided in IRS Publication 54.

5. Multiemployer Plans – Canada

Responsibility – IRS TE/GE and Counsel, Treasury, and Congress

Background

Within Canada, worker mobility from one province to another is facilitated, in part, by plans similar to what are referred to in Canada as “multiemployer plans.” In general, these are plans which are collectively bargained, but may be sponsored and maintained by employers and/or by a union. Because each Canadian province has its own pension rules, these multiemployer plans are essential to Canadian businesses where the employer transfers employees from a workplace in one province to an affiliate located in another province and to ensure the mobility of skilled labor to where it is needed most.

Canadian multiemployer plans typically provide a cents or dollar per hour pension, rather than a compensation or service-based pension. The Canadian plans typically have reciprocal agreements among them that allow contributions for a worker to be made to the worker’s “home” plan. Such plans are particularly important in the construction and entertainment industries. For example, a Canadian entertainer may have several short-term jobs in different provinces in Canada; these agreements would permit benefit accruals or contributions under a qualified Canadian plan to be consolidated into one plan, regardless of where the individual works. However, if a Canadian resident-entertainer works both in the United States and in Canada in a given year, there is limited ability to provide coverage under a Canadian plan relating to the compensation for services rendered in

²⁶ Proposed Treas. Reg. § 1.404A-4, United States and Foreign Law Limitations on Amounts Taken into Account for Qualified Foreign Plans, 58 Fed. Reg. 27219 (May 7, 1993), (“For taxable years beginning after December 31, 1986, the cumulative United States amount, the cumulative foreign amount, and the aggregate amount must be computed in the employer’s functional currency. See generally § 964 and §§ 985 through 989 for rules applicable to determining and translating into dollars the amount of income or loss of foreign branches and earnings and profits (or deficits in earnings and profits) of foreign corporations.”).

the United States. Similarly, Canadian construction workers may work on both United States and Canadian projects each year.

Article 13 of the Fifth Protocol to the United States-Canada 1980 Income Tax Treaty (the "Canadian Protocol") provides for a deduction or exclusion from income in the Contracting State in which the individual is working and covered by a qualifying retirement plan in the other Contracting State provided the individual is not a resident in the other State, but only for certain temporary periods and subject to certain requirements.

Issues

While the multiemployer plan concept is helpful within Canada, challenges arise when workers cross the border to work in the United States or when U.S. residents and workers cross the border to work in Canada. Cross-border work problems include the following:

- Canadians who work in their industry in Canada and then accept temporary assignments in the United States cannot have the U.S. employer's contributions made to the workers' "home" plan in Canada because of United States tax rules, unless the individual can claim benefits under the Canadian Protocol for years beginning on or after January 1, 2009.²⁷
- U.S. employees who temporarily work in Canada cannot have retirement contributions of Canadian employers made to the U.S. employees' "home" plan, unless the Canadian Ministry of Finance approves the U.S. plan, or unless the individual can claim benefits under the Canadian Protocol for years beginning on or after January 1, 2009.
- Vesting schedules differ between Canada (2 years) and the United States (typically 5 or 6 years). This could mean that pensions may be forfeited with respect to work in the United States when those pensions would not be forfeited if the work were performed in Canada.
- It is not easy to provide a Canadian who transfers to a U.S. location with a Canadian pension and a U.S. pension that would add up to the pension that would be earned for employment exclusively in Canada. Further, the plan benefits cannot be transferred from a U.S. qualified plan to a Canadian qualified plan, or vice versa, without tax consequences to the participant and possible disqualification of one or both plans.
- Qualification of a U.S. pension plan is required by Canadian law for workers in Canada to remain in a U.S. pension plan, unless the individual can claim benefits under the Canadian Protocol for years beginning on or

²⁷ There are some plans that are dual-qualified in both Canada and the United States, e.g., the National Hockey League Pension Plan.

after January 1, 2009. This is somewhat similar to dual-qualified plans in Puerto Rico—however, there are stricter pension accrual limits in Canada²⁸ than under the U.S. qualified plan rules, and Canadian plans are not subject to ERISA as are Puerto Rico plans.

- Canadians can accumulate pensions in U.S. plans that meet the requirements of a “Foreign Registered Plan.” This is an exception to the dual qualification requirement, but requires application to the Canada Revenue Agency.
- Canadian tax issues arise if a deferred compensation plan is either unfunded or if an annuity is purchased. There are Canadian law compliance issues if the compensation is pre-funded.

Recommendations

The United States should consider entering into negotiations to allow employer retirement contributions to “follow” a worker. For example, a Canadian working temporarily in Michigan should be permitted to have retirement contributions by the Michigan employer transferred to the worker’s home plan in Canada when the transferred employee returns to Canada.

6. Treaty Issues

Responsibility – IRS LMSB, TE/GE, and Counsel, and Treasury

Background

Other than the minority of instances where alternative provisions are specifically adopted, most pension/annuity articles of bilateral tax treaties with the United States provide that the country of residence (as determined under the treaty’s residency article which contains tie breaker rules when more than one residency is established) may tax a person’s pension or annuity under its domestic laws. Some treaties provide that the country of residence may not tax amounts that would not have been taxable by the other country if the person were a resident of that country. In some cases, government pensions/annuities or social security system payments may be taxable by the government making the payments. There also may be special rules for lump sum distributions. Thus, it is necessary to review each tax treaty independently in order to determine the applicable rules.²⁹

Although many of the bilateral tax treaties address the taxation of distributions from employer pensions/annuities, there are only ten treaties

²⁸ There is a maximum benefit accrual rate of 2% under Canada tax pension rules.

²⁹ See IRS, International Tax Gap Series, *The Taxation of Foreign Pension and Annuity Distributions* (October 2008) available at www.irs.gov/businesses/article/0,,id=187083,00.html.

and two protocols that address the taxation of contributions to employer pensions/annuities.³⁰

The 1996 Model Income Tax Treaty included pension contribution provisions as does the 2006 Model Income Tax Treaty.³¹ The 1996 Model provided that contributions would be deductible (or excludible) for purposes of determining an employee's tax liability in the host country and required that (1) the employee must have been contributing to the home country plan before beginning to work in the host country, (2) the plan must be similar to one for which the home country would provide such a deduction (or exclusion), and (3) the deduction (or exclusion) is limited to the amount that would be allowed for such a plan. It also provided for a deduction to the contributing employer against its taxable income in the host country.³² The 2006 Model also requires that the competent authority of the host State determine that the pension fund to which the contribution is made in the other (residency) State generally corresponds to the plan in the host State.³³ It also provides U.S. tax treatment for certain contributions by or on behalf of U.S. citizens who are residents in another State to pension funds established in that other State that is comparable to the treatment that would be provided for contributions to U.S. pension funds. This tax benefit is limited to the lesser of the amount of relief allowed for contributions and benefits under a pension fund established in the other State and the amount of relief that would be allowed for contributions and benefits under a generally corresponding pension fund established in the United States.³⁴

Each of the bilateral treaties is negotiated between the United States and the other contracting state and results in various permutations. For example, the treaties with Switzerland (1996) and Ireland (1997) impose a five-year limit on how long an employee may qualify for benefits under the provisions. The treaty with the United Kingdom (2001) has special rules for U.S. citizens who live in the U.K. and participate in a U.K. pension scheme. A special commuter provision is included in the Canadian Protocol, which permits

³⁰ These include U.S. treaties with France, The Netherlands, Sweden, Austria, Switzerland, Ireland, the United Kingdom and Belgium, and protocols with Germany and Canada. There is also a pending treaty with Italy. See, Fleeman, M. Grace, *Cross-Border Pension Contributions*, The Tax Journal, June 23, 2008, at 11-12.

³¹ United States Model Income Convention of November 15, 2006, (the "2006 Model Income Tax Treaty"), Article 17 ("Pensions, Social Security, Annuities, Alimony, and Child Support"), Article 18 ("Pension Funds").

³² Fleeman, *supra* note 30, at 12.

³³ The Model Income Convention of September 20, 1996, (the "1996 Model Income Tax Treaty") also contained this requirement in Article 18, paragraph 6(d)(ii).

³⁴ 2006 Model Income Tax Treaty, Article 18; United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, 56-58.

cross-border workers to deduct contributions made to a pension plan or other employment-related retirement plan in the country of employment.³⁵

Many treaties provide relief where the competent authority has determined the types of plans that are covered by the treaty provisions. This requires the U.S. competent authority to agree that the foreign plan generally corresponds to a plan recognized for tax purposes in the United States. In the earlier treaties, each individual desiring to take advantage of the treaty provision (or the plan sponsor) needed to obtain a ruling that the foreign plan generally corresponded to a plan recognized for tax purposes in the United States, requiring submission of all the plan documents (translated into English, if necessary).

The IRS has begun to enter into competent authority agreements with the other contracting state that lists the types of plans in each country that are understood to generally correspond to plans recognized for tax purposes in the other country.³⁶ In some cases these plans are actually listed in the Treaty, the Protocol or the Exchange of Notes relating to the treaty.³⁷

Issues

Not every country that has entered into a bilateral treaty with the United States has compiled an agreed upon list of the approved plans to be covered by the treaty ("comparable plans").

Treaties are robust on protecting "qualified" or "approved" retirement plan accumulations, but do not provide similar protection for non-qualified plans

³⁵ Department of Treasury Technical Explanation of the Protocol Done at Chelsea on September 21, 2007, Amending the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as amended by the Protocols Done on June 14, 1983, March 28, 1984, March 17, 1995, and July 28, 1997, ("Technical Explanation of the U.S.-Canada Protocol") (2008), available at <http://www.treas.gov/press/releases/reports/tecanada08.pdf>. Note, although Roth IRAs are treated as retirement plans under the taxation of distributions from pension plans provision of the U.S.-Canada Protocol, Roth IRAs do not receive the same treatment under the contribution provisions of the Protocol and are treated as taxable contributions to a savings account.

³⁶ Such agreements have been entered into with The Netherlands (2000 and 2007) and Switzerland (2004).

³⁷ See, Protocol Amending the Convention Between the United States of American and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, August 29, 1989, (the "German Protocol") and the United States response to United Kingdom Note regarding the U.S – U.K. Double Taxation Convention, July 24, 2001, (the "U.K. Exchange of Notes). The hierarchy of authority is as follows (in order of importance):

- Treaty
- Protocol
- Exchange of Notes
- Technical Explanation – (either a Treasury unilateral document or the product of negotiation (e.g., Canada))

where they are designed to work with the base retirement plan (“restoration” type plans).

IRAs are not specifically addressed in most treaties³⁸ and need to be contemplated or additional guidance provided. The ACT acknowledges that there is a significant difference of opinion between the US and other countries with whom pension provisions have been negotiated on the characterization of IRAs. The US considers IRAs to be pension plans; other countries consider IRAs to be savings plans in most part due to their “demand account” status. The ACT understands that this may provide a barrier in providing additional guidance in the area.

There are some procedural problems with complying with treaty requirements for filing forms claiming treaty protection. For example, most foreign plans are funded on a monthly or quarterly basis. Thus, where a bilateral treaty has a provision stating that a U.S. Person working in the other country would not have to recognize the contribution to or accrual under a U.S. plan with respect to tax liability in the foreign country, the individual is required to complete and deliver Form W-8BEN to the U.S. payer to take advantage of this treaty provision.

Another procedural problem is presented by the situation in which an employee lives in the United States and receives a pension/annuity from a foreign country. In this situation, the individual must claim the desired treaty withholding exemption on the form and in the manner specified by the foreign government. If the foreign government and/or the foreign withholding agent refuse to honor the treaty claim, the individual may make the treaty claim on his personal income tax return, or other prescribed form, filed with the foreign country. Additionally, a foreign tax credit on the individual's U.S. federal income tax return may be available for any foreign income tax withheld from the foreign pension or annuity.³⁹

Recommendations

- a. Although some bilateral treaties specify the home country pension plans/schemes that are deemed to be comparable,⁴⁰ a number of other treaties do not contain such specificity. Guidance containing general principles that could be applied to determine comparability would be helpful. Perhaps for countries that have an employer-based private pension system, the Code § 409A definition of “broad-based foreign retirement plan” could be used.

³⁸ *But, see*, Canadian Protocol, Article 13, amending Paragraphs 3 and 4 of Article XVIII of the Treaty.

³⁹ See footnote 12 and accompanying text, *supra*.

⁴⁰ See for example, the Technical Explanation to the 2001 U.S. – U.K. Treaty (2003), Art. 3, Par. (o) for a list of the U.S. and U.K. plans that are deemed to be comparable.

- b. An internal working group between Treasury, Chief Counsel, IRS TE/GE Employee Plans, and LMSB should be formalized to address treaty issues and to provide input regarding treaty negotiations. Clarification is needed as to where jurisdiction resides with respect to treaty issues that impact multiple business units within IRS and Treasury. Some of the issues to be reconciled by this working group include the following:
- what constitutes a comparable plan⁴¹ and whether the U.S. and foreign competent authorities can enter into agreements to list comparable plans when the treaty does not contain a list;
 - what constitutes a pension fund in another country (e.g., must the pension fund be a funded plan, must the pension fund meet foreign local requirements, are grantor trusts treated as funded plans in a foreign country);
 - how contributions and dividends to foreign trusts are taxed;
 - what is the permissibility and appropriate treatment of IRAs and rollovers⁴²;
 - whether non-qualified “wrap” or restoration plans can be included as comparable plans; and
 - whether U.S. citizens are taxed on accruals and earnings in other countries.
- c. The IRS should recognize the disconnect between the time at which a determination is made regarding treaty coverage and the time for filing returns required to take advantage of treaty provisions, which is usually after the end of the taxpayer’s tax year, and provide some flexibility as to the time for filing the required forms.
- d. Reconsider the necessity of having nonresident aliens participating in U.S. plans obtain a TIN to be used on required filings to claim treaty relief when no tax revenues are involved.
- e. Treaty negotiators should take into account that retirement income comes from more than one source. Mobile workforces typically need non-qualified benefits to make them whole as they move from country to country.

⁴¹ For example, in France it is difficult to distinguish between the social security system and a pension plan.

⁴² Rollover provisions were not included in the 2006 Model Income Tax Treaty (see footnote 31, *supra*) because of problems with the rollover provisions in the 1996 Model Income Tax Treaty (which were used in the treaty with South Africa).

7. Global Retirement Plans

Responsibility – Treasury and Congress

Background

Many large multinational companies would like to have one retirement plan cover their global workforce, including their U.S. workforce. Such a plan would create economies of scale and administrative consistency.

Issues

Rules such as Code § 409A (Inclusion in Gross Income of Deferred Compensation under Nonqualified Deferred Compensation Plans), nondiscrimination rules under Code § 402(b), and U.S. Department of Labor (DOL) regulations limiting individuals who may be covered by unfunded non-qualified arrangements make the creation of a global retirement plan extremely difficult to achieve on a tax-effective basis.

If all employees are covered under a U.S. 401(k) plan, pre-tax contributions by payroll deductions would be required, but this is difficult administratively, as most off-shore employees are paid through separate payrolls. There is also the issue of compliance with the DOL's requirement on the timing of transferring employee contributions to the trust.

Recommendations

One suggestion is to permit a U.S. parent or affiliate to make contributions on behalf of all employees and matching contributions for all of the participating employers. It is recognized that the impact of other U.S. and foreign laws would have to be considered as well. Similar to other recommendations, the principle underlying this recommendation is that there should be a mechanism to recognize the portability and mobility of employees among U.S. employers with foreign affiliates and foreign employers with U.S. affiliates.

C. Pension Distributions

1. Taxation of Pension Distributions to Nonresident Aliens – Effectively Connected Income under Code § 864

Responsibility – IRS Chief Counsel and Treasury

Background

Code § 864(c)(6), which was enacted in 1986 and is effective for tax years beginning after 1986, provides that income paid in one year for services performed in another year will be treated as income effectively-connected with the United States ("ECI") in the year of payment if it would have been treated as ECI if it had been taken into account in the year the services were performed. Read literally, the rule would not apply if the individual was a

U.S. resident alien or otherwise subject to U.S. taxes in the year the services were performed (because the ECI rules apply only to nonresident aliens).

Issues

Whether the literal reading of the ECI provision articulated above is a correct reading of the rule so as to exclude its application to individuals who were U.S. Persons in the year the services were performed.

Whether the earnings and accretions portion of the distribution from a U.S. pension plan would always be fixed, determinable, annual, periodic (FDAP) income or whether they would be ECI if the contributions are ECI.

Finally, a question arises about the effective date of the provision, namely whether it applies to payments made after 1986 for services performed before 1987.

Recommendations

Guidance is needed with regard to the determination of the portion of a pension distribution to a nonresident alien that constitutes ECI. In addition, the effective date provisions should be clarified.

2. Taxation of Annuities to Nonresident Aliens under Code § 871(f)

Responsibility – Treasury and Congress

Background

Code § 871(f), enacted in 1966, applies when there are a small number of nonresident aliens in a U.S. plan and they leave the United States. If they are paid in the form of an annuity, the distribution is excludable from income.

Issues

Most U.S. employers now provide defined contribution plans or cash balance plans that permit lump sum distributions, which do not qualify for this favorable tax treatment.

Recommendations

Code § 871(f) should be amended to also exclude from income lump sum distributions from qualified trusts and annuities.

3. Direct Rollovers – 402(f) Notice

Responsibility – IRS TE/GE and Counsel, and Treasury

Background

A participant in a U.S. qualified retirement plan in receipt of an eligible rollover distribution under Code §§ 402(c), 403(a)(4), 403(b)(8)(A), and

457(e)(16) must receive a written explanation under Code § 402(f) that describes the tax, rollover options, and withholding applicable to the distribution. The notice requirement is typically satisfied by using a model issued by the IRS⁴³. The IRS model notice is in the process of being modified to reflect recent changes in the tax rules.

Issues

The IRS model 402(f) notice does not reflect the special rules applicable to eligible rollover distributions to nonresident aliens that are not subject to the withholding rules of Code § 3405. The eligible rollover distributions to nonresident aliens that are not rolled over to an eligible retirement plan (including an IRA) may be subject to the withholding rules under Code § 1441 if the distribution is the only U.S. source income, rather than the Code § 3405 rules, which include the 20% mandatory withholding on distributions subject to the direct rollover rules. The withholding under Code § 1441 for distributions not rolled over will result in a withholding rate of 0% to 30% depending on applicable Treaty rates.

Recommendations

The IRS model 402(f) notice should be revised to include language to address the withholding rules under § 1441 that apply instead of the mandatory withholding rules under Code § 3405, for eligible rollover distributions to nonresident aliens not rolled over to an eligible retirement plans (including an IRA).

4. Withholding and Reporting on Pension Distributions to Nonresident Aliens and Certain Expatriates

Responsibility – IRS TE/GE, W&I and Counsel, and Treasury

Background

Exhibit B to this report summarizes the general rules on withholding and reporting pension distributions to nonresident aliens.

Issues

There is a mismatch between amounts withheld and the tax actually owed by a nonresident alien receiving a distribution from a qualified plan, 403(b) plan or IRA that is attributable to effectively-connected income (ECI). Although the individual is taxed at graduated rates on the income, withholding is either automatic at a 30% rate for IRAs or a lesser amount, if the treaty permits, for qualified plan and 403(b) plan distributions. This results in the recipient either having to file and pay estimated taxes if the flat 30% rate (or treaty rate) is too little or having to file for a refund if the 30% rate is too high.

⁴³ IRS Notice 2002-3, 2002-2 I.R.B. 289 (January 14, 2002).

Section 301, Title III, of the HEART Act further compounds the problem. While this tax is aimed at high net-worth individuals who permanently expatriate (by giving up U.S. citizenship or U.S. residency after the date of enactment), it affects the timing and taxation of world-wide assets immediately before expatriation relating to services performed in the United States. Section 301 requires 30% withholding on certain "eligible deferred compensation items," which include distributions from qualified plans, 403(b) and 457(b) plans and other benefit distributions as well as certain transfers of property under Code § 83. The HEART ACT dictates when the 30% withholding requirements apply without regard to lower treaty rates. The obligations of payers of pension distributions are not clear with respect to withholding from affected expatriates.

There are many complex issues relating to tax reporting rules for distributions to nonresident aliens, but they are beyond the scope of this report. One illustrative example is that excess contributions to an IRA or 401(k) plan are reported on IRS Form 1042-S, not on Form 1099-R. The Form 1042-S does not contain a coding system, like that applicable to the 1099-R to indicate to the IRS that a correction of an excess contribution is being made from the payee's account.

Recommendations

- a. An evaluation of the flat 30% rate should be made to determine if another rate or series of rates could be applied so as to more closely relate the flat rate (or the treaty rate) to the actual taxed owed by the nonresident alien.
- b. Guidance should be issued to clarify the new deferred compensation tax under the HEART Act. Guidance is still needed with respect to reporting issues for nonresident aliens, including clarification as to the types of plan distributions that will be subject to this new tax, and whether there are differences between the treatment of distributions from qualified plans, non-qualified plans and IRAs.
- c. Additional guidance and recommendations should be considered by an IRS team, with input from IRPAC, to address the coding and other issues related to reporting nonresident alien distributions from qualified retirement plans and IRAs on IRS Form 1042-S.

5. Puerto Rico

a. ERISA § 1022(i)(1) Plans Covering Puerto Rico Residents Responsibility – IRS TE/GE and Counsel, and Treasury

Background

Revenue Ruling 2008-40⁴⁴ addresses whether a distribution from a trust under a plan qualified under Code § 401(a) to a non-qualified foreign trust is treated as a distribution. It also addresses whether the result is different if the transferee plan trust satisfies the requirements of § 1165(a) of the Puerto Rico Internal Revenue Code (“PR Code”) and is described in § 1022(i)(1) of ERISA (a “1022(i)(1) Transferee Plan”). The ruling concluded that, in both instances, the transfer of amounts from the U.S. qualified trust is treated as a taxable distribution from the transferor plan. The Ruling also provides limited transition relief for a transfer prior to January 1, 2011, to a 1022(i)(1) Transferee Plan that would satisfy the requirements of Code § 414(l) but for the fact that the transferee trust is not a qualified trust within the meaning of § 401(a).⁴⁵

The transition relief provides that (1) the portion of each distribution from a 1022(i)(1) Transferee Plan that is attributable to amounts that were transferred from a U.S. qualified plan before January 1, 2011, will be treated as income from sources within Puerto Rico and (2) employees participating under a 1022(i)(1) Transferee Plan may be treated as excludable employees for purposes of applying Code § 410(b) with respect to the U.S. transferor plan for plan years beginning prior to January 1, 2011, if either (a) the U.S. plan would satisfy the requirements of Code § 410(b) if the U.S. plan and the 1022(i)(1) Transferee Plan were aggregated for testing purposes, and the U.S. plan by itself would satisfy the average deferral percentage test of Code § 401(k)(3) (disregarding Code § 401(k)(3)(A)(i)) and the average contribution test of Code § 401(m), if applicable; or (b) in the case of a defined contribution plan that provides for contributions other than elective contributions for employees benefiting under the 1022(i)(1) Transferee Plan, the rate of such contributions following the transfer date is not reduced from the rate under the U.S. plan prior to the transfer date.

Issues

Although Rev. Rul. 2008-40 addressed and answered a number of issues that arise with respect to spinning off a portion of a plan qualified both under Code § 401(a) and § 1065(a) of the PR Code (a dual-qualified plan), it did not address a number of issues that are still outstanding, including whether

⁴⁴ Rev. Rul. 2008-40, 2008-30 I.R.B. 166 (July 28, 2008).

⁴⁵ Even more limited transition relief was provided for a transfer to a qualified funded plan under Code § 404A(f)(1) where the employer elects to have Code § 404A apply to the plan. In that case the holdings of Rev. Rul. 2008-40 do not apply if the transfer was made before October 1, 2008.

the assets of a 1022(i)(1) Transferee Plan may be co-invested with qualified plan assets in a group trust under Rev. Rul. 81-100⁴⁶ or in the U.S. master trust of a controlled group member.

Beginning in 2011 when the transition relief relating to Code § 410(b) testing for U.S. qualified defined contribution plans is no longer available, employees resident in Puerto Rico who participate in a 1022(i)(1) Transferee Plan and are employed by a plan sponsor (or by a member of the same controlled group, within the meaning of Code § 414(b) and (c), as a plan sponsor) of one or more U.S. qualified plans will be required to be taken into account for purposes of applying Code § 410(b) to the transferor plan and other U.S. qualified plans maintained by members of the controlled group. Because the benefits provided under the 1022(i)(1) Transferee Plan are not counted under Code § 410(b), it will be more difficult to pass these nondiscrimination tests.

Recommendations

Although Rev. Rul. 2008-40 provides transition relief, the underlying analysis and conclusion that transfers of assets from a qualified plan to a 1022(i)(1) Transferee Plan will disqualify the qualified pension plan should be reconsidered, and the transition rule made permanent, for the following reasons:

- There may well be situations after 2010 in which an employer who established a separate 1022(i)(1) Transferee Plan or initially established a Puerto Rico-only qualified plan for employees resident in Puerto Rico acquires a company with a dual-qualified plan. The successor employer will no longer be able to divide the plans and transfer the assets for the Puerto Rico employees from the newly acquired entity's dual-qualified plan to a 1022(i)(1) Transferee Plan without disqualifying the transferor U.S. qualified plan;
- The PR Code contains different definitions of highly compensated employees, different limits on covered compensation and different ADP and ACP testing;
- Further, recent amendments to the PR Code relating to the taxation of distributions from plans qualified under Section 1165 of the PR Code provide more beneficial tax results than can be provided to dual-qualified plans,⁴⁷ which make it administratively more difficult to maintain dual-qualified plans;

⁴⁶ See Groom Law Group Letter to Treasury Department on Group Trust Arrangements, dated December 4, 2008.

⁴⁷ See Puerto Rico Act 181, December 10, 2007, ("Act 181"). Act 181 amended PR Code § 1165, retroactive to January 30, 2006, to reduce to 10% the capital gains rate applicable to lump sum distributions if certain requirements are satisfied. However, the general 20% income tax and

- 1022(i)(1) Transferee Plans are subject to ERISA, cover U.S. citizens and are subject to similar (although not exactly the same) broad coverage and nondiscrimination requirements as U.S. qualified plans; and
- Under the Rev. Rul. 2008-40 transition relief, employees covered by a 1022(i)(1) Transferee Plan may be excluded from the application of Code § 410(b) when testing the coverage and benefits of employees remaining in the transferor plan (assuming the other requirements of the relief are met). However, this will become a testing issue beginning in 2011 and may already be one for Puerto Rico plans that were initially established as 1022(i)(1) Transferee Plans. Although these plans are not subject to the nondiscrimination requirements of Code § 401(a), by law they do need to meet the requirements of § 1165(a) of the PR Code. Consideration should be given to amending the requirements under the qualified separate line of business (QSLOB) regulations⁴⁸ to automatically treat 1022(i)(1) Transferee Plans as meeting the QSLOB requirements. If such a change is made, the employees covered by a 1022(i)(1) Transferee Plan could continue to be excluded from testing under Code § 410(b) of U.S. qualified plans maintained by another member of the same controlled group

b. Asset Pooling – Revenue Ruling 81-100⁴⁹

Responsibility – IRS TE/GE and Counsel, and Treasury

Background

Revenue Ruling 81-100, as clarified and modified by Rev. Rul. 2004-67⁵⁰, provides that if certain criteria are satisfied, a trust that is part of a qualified retirement plan, an individual retirement account exempt from tax under Code § 408(e) or an eligible governmental plan under Code § 457(b) may pool its assets in a group trust without adversely affecting the tax status of any of the separate trusts or the group trust.

Issues

It is not clear under current law whether a group trust must satisfy the requirements of Rev. Rul. 81-100 if all of the participating plans are maintained by entities within the same controlled group and invest directly in the group trust rather than through separate trusts. Code § 401(a) provides that a trust is a qualified trust if, among other things, (1) it is part of a pension or profit sharing plan and (2) it, and the plan of which it is a part, satisfy the

withholding rate applies to lump sum distributions paid from a U.S. situs trust with no Puerto Rico co-trustee acting as paying agent.

⁴⁸ Treas. Reg. § 1.414(r).

⁴⁹ Rev. Rul. 81-100, 1981-1 C.B. 326 (January 1981).

⁵⁰ Rev. Rul. 2004-67, 2004-28 I.R.B. 28 (July 12, 2004).

requirements of Code § 401(a).⁵¹ No additional requirements are imposed on a trust merely because it takes the form of a sub-account in a group trust. Revenue Ruling 81-100 by its terms applies only to group trusts in which there are separate "participating trusts."⁵²

Master trusts also satisfy all of the requirements of Rev. Rul. 81-100. The second requirement of Revenue Ruling 81-100 could be affected by the inclusion of an ERISA § 1022(i)(1) plan trust, namely that the group trust instrument expressly limit participation to, among other things, pension, profit sharing and stock bonus trusts or custodial accounts qualifying under Code § 401(a) that are exempt under Code § 501(a). For purposes of Code § 501(a), an ERISA § 1022(i)(1) plan is treated as an organization described in Code § 401(a), provided such plan is exempt from taxation under the PR Code.

Recommendations

Issue guidance clarifying that an ERISA § 1022(i)(1) plan trust is permitted to co-invest in a qualified group trust under Rev. Rul. 81-100.

6. Special Tax Issues for Guam and Mariana Islands⁵³

a. Taxation of Distributions to Guam Residents

Responsibility – IRS TE/GE, LMSB, and Counsel, and Treasury

Background

Many issues are faced in connection with the taxation of distributions to Guam residents participating in U.S. pension plans and the treatment of pension plans maintained by Guam employers. Guam has adopted a mirror image of the Code.

With regard to taxation of distributions to Guam residents who have worked for part of their service in Guam and part in the United States, the issue of allocating the taxes and remitting them to Guam and the United States has been a continuing problem. The Guam resident is subject to Guam income tax on distributions of the employer contributions and employee contributions to the plan made while working in Guam and the remainder is subject to tax

⁵¹ See also Treas. Reg. § 1.401-1(a)(3)(ii) (July 1989).

⁵² Cf. Rev. Rul. 69-421, Part 2(e), 1969-2 C.B. 59 (citing Rev. Rul. 56-267, 1956-1 C.B. 206 (January 1956), the predecessor to Rev. Rul. 81-100, in its description of rules for plans and trusts of multiple employers).

⁵³ Similar issues may also exist with respect to employees in the U.S. Virgin Islands and American Samoa, but the ACT did not uncover specific issues in the due diligence process. The ACT did learn that there may be IRS authority providing for payers of U.S. pension plan distributions to certain American Samoans to forward taxes withheld from those distributions directly to the American Samoa tax authorities rather than to the IRS, but the ACT was unable to locate this authority.

in the United States. The entire earnings portion is sourced based on where the trust is located.⁵⁴

Issues

If a pension plan is a U.S. qualified plan, the tax withholding rules of Code § 3405 apply and all withholding is to be remitted to the United States. There is no provision for submitting part of the withholding to possessions treated as foreign, such as Guam, which therefore must issue a Form 1042-S rather than a 1099-R.

Recommendations

The ACT considered the following possible solutions but determined that each has its own problems:

1. Use the address of the participant when the distribution is made to determine the tax authority to receive withholding. Thus, if the participant has a Guam address, then the withholding would be paid to Guam. If the participant has a U.S. address (or address outside of the U.S. but not in Guam), the withholding would be paid to the IRS.
2. Track the earnings of the individual based on service in Guam and service in the United States. Some employers may maintain this information but the technology necessary to maintain these records is not available to the vast majority of plan trustees and third-party administrators. Even if this alternative could be implemented, the plan trustee would pay withholding to two places, Guam and the IRS, but would issue only one 1099-R/1042-S. The 1099-R/1042-S should contain boxes for allocation of the income to another U.S. territory or possession.
3. Use the place of business of the plan trustee to determine whether the tax should be paid to the IRS or Guam. If the place of business of the trustee is in Guam, then the withholding would be paid to Guam. If the place of business is in the United States, then the withholding would be paid to the IRS.

The problem with all three approaches is that the withholding agent may not be told where the recipient works or how services should be allocated between the United States and Guam. In addition, amounts withheld may not be paid to the tax authority that has the authority to tax the distribution.

It would make little difference which tax authority received the withholding if the participant has the information required to determine the amount of the distribution that should be taxed by each jurisdiction and the jurisdictions

⁵⁴ See Rev. Rul. 2008-40, 2008-30, I.R.B. 166 (July 1, 2008), Rev. Rul. 79-388, 1979-2, C.B. 270 (July 1979), and Rev. Proc. 2004-37, 2004-26 I.R.B. 1099 (June 28, 2004).

have a mechanism to transfer the withholding and other tax payments to match the tax liability.

Therefore, the recommendation is that guidance be issued indicating that all withholding is required to be remitted to the IRS, unless the affected taxpayer takes the initiative of prorating plan contributions between the United States and the territories and informs the withholding agent of the allocation. In addition, a Memorandum of Understanding (or other appropriate agreement) should be entered into with the affected territories to provide for remittance of a certain percentage of collected withholdings, based on a rational basis related to the likely amount that would have been remitted to such authorities had the actual amounts due been remitted directly to the affected tax authorities using an average for a specified period of years.

The ACT understands that LMSB is dealing with similar issues with foreign governments pursuant to Code § 932 (Coordination of United States and Virgin Island income taxes), and recommends coordination with LMSB in implementing a solution with respect to Guam and Mariana Islands residents.

b. Treatment of Pension Plans Maintained in Guam

Responsibility – Treasury and Congress

Background

A pension plan maintained in Guam that invests in shares of stock of a U.S. corporation or other funds maintained in the United States is not considered to be maintaining a foreign grantor trust under Code §§ 404(a)(4) and 402(c) and (d), but is treated as a tax-exempt trust under Code § 501(a). Specifically, Code § 402(c) precludes treatment of the trust as a grantor trust.

Issues

Even though the Guam plan trust is treated as tax exempt under Code § 501(a) for purposes of allowing deductions for contributions, taxation of distributions and allowing rollovers to an IRA or another qualified plan under Code §§ 402 and 404, the trust is a foreign trust subject to mandatory withholding on dividends paid by U.S. corporations to the plan's trust under Code § 1441. The trust is not given full status of a tax-exempt trust under § 501(a) but merely treated as tax exempt for limited purposes.

Recommendations

Treat a Guam plan trust exempt from tax under Code § 501(a) as also exempt from the withholding requirements of Code § 1441.

c. Estate Tax on Organic Act Citizens

Responsibility – Treasury and Congress

Background

Certain residents of Guam who are citizens of the United States by reason of their Guam residency are treated as nonresidents (i.e., not citizens) under Code § 2209. These residents are commonly known as “Organic Act Citizens.”

The estates of Organic Act Citizens are not subject to the U.S. federal estate tax with respect to assets outside of the 50 states. However, their estates are subject to the federal estate tax on securities issued by the United States and U.S. corporations and real property located in the 50 states.

An Organic Act Citizen may be a participant in a qualified plan or own an IRA that invests in U.S. securities and real property located in the 50 states (“U.S. Assets”).

Issues

Whether plan benefits or IRA assets, to the extent that they are U.S. Assets, are subject to U.S. federal estate tax.

Recommendations

To the extent that a participant (or beneficiary) of a qualified plan is not entitled to a distribution of the plan assets in kind, the investment by the plan in U.S. Assets should not cause any portion of the pension to be considered a U.S. Asset subject to the estate tax upon the death of an Organic Act Citizen. It would be desirable to treat IRAs the same way to the extent that it could be shown that the IRA assets could not or would not be distributed in kind.

7. Rollovers from Foreign Plans to U.S. Plans and IRAs (U.K. Example)

Responsibility – IRS TE/GE and Counsel, Treasury and Congress

Background

For a number of years there has been much confusion over the tax treatment of impermissible rollovers from foreign-based retirement plans to U.S. qualified retirement plans. To add to this confusion, many websites, including those of the foreign-based plans, are not only informing participants in the foreign plans that such rollovers are permitted, but are also providing names of U.S. investment companies that will accept such rollovers to an IRA.

The issue has been further complicated by plans that are offered to employees of companies that are located in a U.S. possession (such as Puerto Rico) where the question has also been raised as to whether terminating participants may roll over distributions to a U.S.-based IRA or qualified retirement plan.

In August 2008, an IRS Memorandum issued by the Associate Chief Counsel (International) to Michael Julianelle, Director of Employee Plans (TE/GE)⁵⁵ examined a rollover issue related to a very specific transaction under the U.K. pension scheme rules. The issue addressed was whether an individual who is a resident of the U.S. may rely on the parenthetical language in Article 18(1) of the U.S.-U.K. income tax treaty to make a tax-deferred rollover distribution from a U.K. pension scheme to a U.S. retirement plan where the distribution would not qualify as an “eligible rollover distribution” within the meaning of Code § 402(c)(4). The Memorandum stated that there was nothing under Article 18 of the U.S.-U.K. treaty that would permit such a tax-deferred rollover to be recognized.

Issues

Additional questions arising under other treaties have not been specifically addressed, nor has the situation been addressed with respect to rollovers from pension plans of U.S. possessions. Although the Memorandum referred to above may not be cited as precedent, and does not provide guidance with respect to all of the rollover scenarios, it can be assumed from the authority cited that these transactions, unless treated otherwise in future guidance, cannot be made under the current structure of Code § 402.

Recommendations

Acknowledging that there would be a tax cost, rollovers to U.S. qualified plans or IRAs should be permitted from approved “broad-based foreign retirement plans” meeting the Code § 409A definition.⁵⁶ This result would provide more flexibility for cross-border mobile employees. The European Union has already approved this concept.

8. The Rights of Multiple Spouses

Responsibility – IRS TE/GE and Counsel, and Treasury

Background

Qualified plans may cover participants who under local law have more than one legal spouse. For example, in many Middle Eastern countries, local law recognizes that a man may have more than one wife. In other countries, a woman may have more than one husband.

⁵⁵ Memorandum from Associate Chief Counsel (International) to Michael Julianelle (Director Employee Plans TE/GE), Memorandum No. AM2008-009 (August 21, 2008).

⁵⁶ See Treas. Reg. § 1.409A-1(a)(3)(v).

Issues

Where a participant with multiple spouses participates in a U.S. qualified plan, the following issues need to be addressed:

- a. What law controls the definition of marriage and legal spouse?
- b. If the plan is required to provide a qualified joint and survivor annuity, would only the first spouse be entitled to such coverage or would each spouse be entitled to an allocable share? With respect to qualified optional survivor annuities, do all of the spouses have to agree on the same form of annuity?
- c. With respect to waiver of the qualified joint and survivor annuity or a death benefit in a defined contribution plan, do all of the spouses have to agree?
- d. With respect to QDROs, what court's decision controls? What if local law does not require a court order?

Recommendations

The IRS should consider these issues and provide appropriate guidance for plan administrators. Plan administrators would prefer a requirement that the participant name one spouse to receive the protections under U.S. laws. Clarification is needed as to how the federal Defense of Marriage Act⁵⁷ ("DOMA") would apply in these circumstances.

D. NON-QUALIFIED DEFERRED COMPENSATION

1. Taxation of Funded Foreign Deferred Compensation Plan under Code § 402(b)(4)

Responsibility – IRS Counsel, Treasury, and Congress

Background

Many foreign deferred compensation plans are exempt from the requirements of Code § 409A, but U.S. Persons who participate in funded, non-U.S. retirement plans may be subject to taxation under Code § 402(b) (Taxability of Beneficiary of Nonexempt Trust).

Regulations under 409A exclude from the definition of "non-qualified deferred compensation" certain foreign plans where (1) there is an

⁵⁷ P.L. 104-199 (September 21, 1996), 110 Stat. 2419 (codified at 1 U.S.C. § 7 and 28 U.S.C. § 1738C). Under DOMA, the term "marriage" means only a legal union between one man and one woman as husband and wife, and the term "spouse" refers only to a person of the opposite sex who is a husband or wife, for purposes of determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States.

applicable treaty, (2) the plan is a “broad-based foreign retirement plan” under 409A, or (3) the plan is subject to a totalization agreement.⁵⁸ However, if the foreign plan is funded, unless there is treaty relief, a U.S. Person must include in income an amount calculated under Code § 402(b)(4). This rule applies for purposes of determining the amount that highly compensated employees must recognize when one of the reasons the plan is not exempt under Code § 501(a) is its failure to satisfy the coverage testing under Code §§ 401(a)(26) or 410(b). But, a failure to satisfy the coverage testing may be attributable to the requirement to ignore coverage of nonresident aliens who participate in the plan along with U.S. expatriates.

Issues

Even though a foreign plan is in fact broad-based, the IRS treats all amounts accrued as discriminatory, since the nonresident aliens actually participating in the foreign plan are not taken into account.

This causes the U.S. participants to be subject to the relatively less favorable rules of Code § 402(b)(4), which taxes the employee on his entire vested accrued benefit in the trust at the close of the taxable year of the trust in which it was not exempt under Code § 501(a) rather than the rules of Code § 402(b)(1), which taxes the employee on the employer's contributions to the trust during the employer's applicable taxable year for which the trust is not exempt, to the extent the employee's interest in the trust is vested.

Recommendations

- a. As under the 409A regulations, the IRS should adopt similar exclusions for purposes of Code § 402(b) for foreign broad-based plans by (1) permitting the rules under Code § 402(b)(1) to apply and (b) allowing nonresident aliens who are actually participating in the plan to be taken into account to determine whether the plan meets the Code § 410(b) coverage rules solely for purposes of applying Code § 402(b).
- b. Provide for a transition rule to allow non-compliant plans to become compliant after communicating the rules in connection with the foregoing recommendation.
- c. Code § 402(b)(4) requires a taxpayer who is a highly-compensated employee to declare as income his accrued benefit at the end of the year less any amounts previously declared and recognized. To encourage compliance, a transition rule should be adopted in the first year the taxpayer makes the declaration.

⁵⁸ Treas. Reg. § 1.409A-1(a)(3). A totalization agreement is an international Social Security Agreement, which eliminates an individual having to pay taxes to two Social Security Systems (U.S. and foreign country) and attempts to make the individual whole with regard to Social Security benefits when splitting a career between the U.S. and a foreign country.

- d. It is the ACT's understanding that Code § 402(b)(4) was never intended to apply to foreign pension plans that were established as non-qualified plans. This is confirmed by the legislative history which shows that Code § 402(b)(4) was intended to apply to previously qualified plans that become disqualified due to discrimination testing under the tighter rules after 1986. Clarifying guidance on this point should be issued.
- e. If Code § 402(b)(1) can be used to determine the includable amount (based on the changes suggested above), there also should be a rule adopted for administrative ease under which the actuary of the foreign plan certifies that a specific approved actuarial method is being used and the contribution to be made for the year on an aggregate basis is a percentage of covered compensation. This will solve the problem created by the fact that, in many situations, there are more than one or two U.S. Persons in the foreign plan, and it is difficult and expensive to have the actuary provide individual calculations.⁵⁹

⁵⁹ See, e.g., Rev. Rul. 2004-3, 2004 -7 I.R.B. 486 (February 17, 2004), addressing allocation of U.S. income under the U.S./German Treaty to a nonresident alien partner when the partnership has a U.S. office.

VI. EDUCATION AND OUTREACH ON INTERNATIONAL PENSION ISSUES

Responsibility – IRS TE/GE, LMSB, SBSE, and W&I

This section of the report highlights areas for which education and outreach could lead to greater compliance with pension plan qualification rules, as well as with the rules applicable to reporting and withholding on distributions to U.S. Persons working abroad and to nonresident aliens working in the United States. Special consideration should be given to education and outreach with regard to compliance with rules involving participants in pension plans maintained in U.S. possessions and territories and for those residents who participate in U.S. pension plans.

A. Summary of Tax Rules for Reporting and Withholding on Pension and IRA Distributions to Nonresident Aliens

Exhibit B of this report sets forth some general information on reporting and withholding on distributions to nonresident aliens and expatriates from U.S. qualified retirement plans and IRAs as an informational piece that could form the basis for an article or other educational piece for the IRS website and other outreach and educational efforts. Since the rules are set forth in various Code sections and there is not a single IRS source for this type of information, it would be helpful to have a general guide like this as a useful tool to employers, withholding agents and taxpayers. Exhibit B also contains a sample worksheet as well as a flowchart describing the presumption rules. With many penalties being assessed by LMSB (more recently a financial organization was charged \$780 million for improper withholding and reporting), it is clearly evident that education materials and assistance to payers is needed.

B. Proposed New Publication – U.S. Qualified Retirement Plans: Cross-Border Transactions

There is a notable lack of guidance directed toward U.S. employers who sponsor qualified plans covering an international workforce. The IRS has issued many publications on cross-border tax issues. However, these publications focus on individuals,⁶⁰ not employers or plan sponsors. The only IRS publication addressing some of the cross-border tax issues

⁶⁰ IRS Publication 593, *Tax Highlights for U.S. Citizens and Residents Going Abroad* (December 2008), identifies three other useful publications that provide greater details on foreign income, foreign tax credit and general tax treaty benefits; IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad* (November 2008); IRS Publication 514, *Foreign Tax Credit for Individuals* (March 2007); and IRS Publication 901, *U.S. Tax Treaties* (April 2009). Other IRS publications addressing cross-border tax issues for individuals include IRS Publication 4732, *Federal Information for U.S. Taxpayers Living Abroad* (January 2009); IRS Publication 516, *U.S. Government Civilian Employees Stationed Abroad* (January 2009); IRS Publication 4588, *Basic Tax for Green Card Holders* (October 2006); IRS Publication 513, *Tax Information for Visitors to the United States* (March 2009); IRS Publication 519, *U.S. Tax Guide for Aliens* (April 2008); and IRS Publication 678-FS, *Foreign Student and Scholar Text* (2007).

addressed in this report is Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*.

Exhibit E of this report is a draft of a proposed new publication addressing the U.S. income tax consequences for (1) U.S. Persons who remain covered under a U.S. qualified plan even though they have been transferred to work in another country ("outbound workers") and (2) nonresident aliens transferred from another country to work in the United States that are covered by a U.S. qualified plan ("inbound workers"). The targeted audience for the publication is an employer that sponsors a U.S. qualified plan.

The IRS should review this draft publication and consider issuing it in full or in part initially as informational material on its website, with the view towards having it ultimately be reviewed and edited to become an IRS Publication.⁶¹

C. Proposed Frequently Asked Questions Regarding Taxation of Distributions to Guam residents from U.S and Guam Plans

Part V of this report includes a discussion of special issues relating to the taxation of pension distributions to residents of Guam and Mariana Islands who participate in plans sponsored by U.S. or Guam employers.

Attached as Exhibit F to this report are sample questions and answers that the IRS might consider as the starting point for Frequently Asked Questions to be published on the IRS website as part of its education and outreach efforts. The questions and answers use some examples to address some general rules regarding the proper tax treatment of distributions from either U.S. based plans or plans maintained in Guam.

D. Revisions to Existing IRS Publications

Exhibit A of this report lists 15 different IRS Publications primarily dealing with the income taxation of individuals who are U.S. taxpayers going abroad or foreign citizens working in the United States. The ACT understands that each IRS Publication has an owner. It is recommended that an International Publications task force be formed, consisting of the owners of the IRS Publications addressing foreign pension issues.

Noticeably absent is an IRS Publication for employers regarding qualified and non-qualified retirement plans and IRAs. Consideration should be given to the development of such a Publication or a single source that identifies the various publications and the issues they address.

⁶¹ The IRS might also consider expanding the publication (or issuing a separate publication) to address the U.S. income tax consequences when a U.S. employer sponsors a non-qualified deferred compensation plan that covers outbound and inbound workers.

In addition, the following is a list of suggested revisions to the existing publications.

1. Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*

The IRS should consider updating this publication's treaty provisions to specifically address whether or not the treaties cover IRAs.

2. Publication 593 (December 2008), *Tax Highlights for U.S. Citizens and Residents Going Abroad*

While Publication 593⁶² provides a summary of many cross-border tax issues for U.S. Persons going abroad, it omits one significant issue—contributions or accruals under retirement or deferred compensation plans – which applies whether these U.S. Persons participate in a foreign plan or a U.S. plan.

U.S. Persons working in a foreign country but covered under a U.S. qualified plan will not be currently taxed in the United States on contributions under a defined contribution plan or on accruals under a defined benefit plan. However, the foreign country may impose income taxes⁶³ on these workers for such contributions or accruals.

Similarly, U.S. Persons working in a foreign country and covered under a foreign plan may not be currently taxed in the foreign country on contributions or accruals under the foreign plan. However, the U.S. may impose income taxes on these U.S. Persons for such contributions or accruals.

Some U.S. bilateral income tax treaties with foreign countries provide relief for U.S. Persons working in a foreign country and covered by a U.S. or a foreign retirement plan.

Code § 409A (Non-Qualified Deferred Compensation) also could apply when a U.S. Person is covered under a foreign plan. However, the Code § 409A regulations⁶⁴ exclude deferrals under a foreign plan if:

- The deferrals of foreign earned income are excludable for U.S. income tax purposes under an applicable income tax treaty;

⁶² Available at <http://www.irs.gov/pub/irs-pdf/p593.pdf>.

⁶³ The foreign taxation of U.S. Persons going abroad is beyond the scope of IRS Publication 593.

⁶⁴ Treas. Reg. §§ 1.409A-1(a)(3), (b)(8).

- The plan is broad-based, the U.S. Person is not eligible to participate in a U.S. qualified plan, and the nonelective deferrals of foreign earned income do not exceed the Code § 415 limits that would apply if the plan were a U.S. qualified plan; or
- The deferrals would be excluded as foreign earned income under Code § 911 if the amounts had been paid, instead of deferred, when earned.

Publication 593 need not thoroughly explore the income taxation of contributions or accruals for U.S. Persons going abroad who participate in a foreign plan or a U.S. qualified or non-qualified retirement plan. However, Publication 593 should make a U.S. Person aware that those contributions or accruals could create an income tax issue under foreign and U.S. law if the United States has not entered a bilateral income tax treaty with the foreign country related to those contributions or accruals.

E. Education and Outreach on Coverage, Nondiscrimination Testing, and Controlled Group/QSLOB Rules

Treasury Regulations require that plan sponsors satisfy myriad minimum benefit, participation and coverage standards. These standards require the performance of tests (most required on an annual basis) that involve the collection and organization of detailed employee census data (including compensation, birth dates, service dates, job classification, ownership percentages, etc.). Further, this data must be collected and organized from all members of the plan sponsor's controlled group and employers under common control with the sponsor, as determined under Code §§ 414 and 1563. (For the remainder of this Section E, the term "Controlled Group" includes all the entities required to be considered as a single employer under the applicable Code sections.) Members of a Controlled Group are determined without regard to whether the plan sponsor and its affiliated companies are foreign-based or foreign-owned.

Following are some particular areas where education and outreach is necessary to improve compliance while recognizing the challenges employers face in gathering the information needed to meet the various coverage and nondiscrimination requirements on a controlled group basis.

1. Controlled Groups

Members of the same Controlled Group must be aggregated for coverage and other testing purposes. The determination of who is a member of a Controlled Group is determined on the basis of common ownership among the employers being considered. Many U.S.-based plan sponsors who are subsidiaries of a foreign entity or a joint venture between two or more foreign entities, or a joint venture between a U.S.-based company and a foreign entity, are unable to obtain enough information about the ownership interest

of the foreign entity(ies) to determine if they are a part of a Controlled Group with other U.S.-based subsidiaries who share ownership with the plan sponsor. Thus, Controlled Group status is often undetermined and can go undetected, meaning coverage and other qualification requirements are not being satisfied. Furthermore, plan sponsors are often confused about the treatment of employees who transfer to another member of the Controlled Group, particularly when the transfer is to or from a foreign entity within the Controlled Group. For example, is a distribution permitted in the case of such a transfer, and is prior service with the foreign entity credited for eligibility, vesting and benefit accrual purposes?

2. Qualified Separate Line of Business (QSLOB)

The QSLOB rules under Code § 414(r) may be used to determine whether a business meets the requirements of Code § 401(a)(26) and Code § 410(b). Employers who are members of the same Controlled Group may apply to the IRS for a determination as to whether or not the Controlled Group operates as two or more QSLOBs.⁶⁵ If the Controlled Group can satisfy the QSLOB requirements, the plan sponsor is able to meet the various qualification requirements and perform certain tests as if each QSLOB is a stand-alone entity, thus disregarding other members of the Controlled Group for coverage and nondiscrimination testing purposes. Difficulties arise in filing for a QSLOB determination with the IRS in determining who is considered the “employer” for purposes of filing the required Notice and submitting to the IRS a request for determination to satisfy administrative scrutiny. For example, if the parent company is a foreign entity, is it considered the employer and is it required to make the QSLOB application and filings?

3. Data Privacy Issues

As mentioned above, the coverage, participation and other qualification testing under the Code requires extensive employee data for all members of the Controlled Group (regardless of whether the employees are receiving U.S.-source income). When the Controlled Group includes foreign entities, this presents difficulties due to foreign rules, regulations, and customs concerning what data may be disseminated and to whom. Thus, even when U.S.-based plans are sponsored by members of a known Controlled Group, the required testing can be difficult to perform.

⁶⁵ If the Controlled Group members qualify under the statutory or regulatory safe harbors, an individual determination by the IRS is not necessary.

4. Employee Transfers

An increasing number of employees are being asked to take assignments overseas, and more U.S. citizens are being employed by foreign entities. Plan sponsors should be able to adopt a benefits strategy that does not economically disadvantage plan participants by the accrual of benefits or allocation of contributions merely due to the ownership structure of their employer and its related entities or as a consequence of their transfer of employment to a related foreign entity. However, the rules and regulations concerning such situations are confusing to plan sponsors and employers or fail to provide adequate guidance, resulting in a lack of coordination of benefit plans or, worse, disqualification.

5. IRS Presentations on Reporting and Withholding Requirements

TE/GE should coordinate with LMSB to expand its existing withholding and reporting presentations to reflect international pensions for the benefit community.

Education and outreach efforts should be designed to:

- a. Increase awareness among plan sponsors of the necessity to take into consideration all members of the Controlled Group to which they belong, including foreign parent companies and any subsidiaries in the Controlled Group.
- b. Increase awareness among foreign corporations that pay U.S.-based income of the necessity to make Controlled Group determinations and QSLOB applications.
- c. Provide guidance on international and cross-border retirement plan issues to allow plan sponsors to adapt to and plan for an increasingly global economy and work force.
- d. Make plan sponsors and employers aware of the potential consequences of transferring to a foreign entity within their employer's Controlled Group to enable them to adopt benefit plan strategies that keep employees from suffering financial harm with respect to their benefits.

F. IRS Website

The ACT suggests the following recommendations regarding the IRS website to further promote education and outreach to the various stakeholders and practitioners with respect to international pension issues:

- a. Create and maintain a dedicated section of the IRS website for international pensions and include a link to that site on the general retirement plans website as well as on LMSB, W&I, and SBSE websites.

- b. Create and maintain a dedicated email address for comments and questions to be submitted regarding all facets of international pensions, and post FAQs with answers.
- c. Post this ACT report on the IRS retirement plans website and on any international pensions website (recommended above), along with a request for information to be submitted via the international pensions email address (recommended above) to assist IRS with its efforts in learning more about the issues raised in this report and to obtain more anecdotal examples of the problems, assistance with prioritizing the needs and additional ideas as to how needed changes can be implemented by IRS or otherwise.

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VII. CONCLUSION

There is a substantial gap in the level of assistance the IRS provides to employers compared to the level of assistance it provides to individual taxpayers regarding international pension/tax matters. This can be remedied, in part, by a unified team approach, which should include representatives of each of the IRS business units, including TE/GE Employee Plans, and representatives from the Department of Treasury.

Addressing the issues raised in this report regarding problematic sections of the Internal Revenue Code, Treasury regulations, and treaty provisions can remove impediments and improve the provision of retirement benefits by employers to a mobile and globalized workforce.

Education and outreach is critical to improving compliance in the international retirement plans arena. A task force consisting of the “owners” of the various IRS publications on international pension and tax issues should undertake a project to centralize the materials on a single IRS website, perhaps containing fewer, more topic-oriented and comprehensive publications, to replace the various materials from a variety of business units.

As with other efforts to promote tax compliance, education and outreach, and “soft contact compliance checks” should be undertaken before any significant audit projects begin with respect to international pension compliance.

This report can be utilized as a checklist, with the implementation of recommended changes serving as further steps towards fulfillment of the IRS' role in breaking down the barriers that employers and employees face in providing, administering, and reporting international pensions in compliance with U.S. tax law.

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**EXHIBIT A. Information Obtained from Keyword
Search - "IRS Publications International" - on IRS
Website at www.irs.gov**

1. International Taxpayer

This page, which can be found at www.irs.gov/businesses/small/international/index.html contains a list of IRS materials focused primarily on the individual international taxpayer. Among the items referenced on this page are the following notable links:

a. Servicewide Approach to International Tax Administration⁶⁶

This page outlines the IRS' initiative to improve taxpayer services, enhance enforcement of tax laws, and modernize the IRS through its people, processes, and technology. The initiative appears to be geared primarily toward taxpayer services for individuals.

b. Alien Taxation – Certain Essential Concepts⁶⁷

This page is under SBSE and provides general information about the U.S. taxation of aliens.

c. Help With Tax Questions – International Taxpayers⁶⁸

International taxpayers are directed to this page of the IRS website to ask questions via the internet or to call a special phone number for taxpayer assistance. This web page appears to be geared primarily to individual taxpayers, not to employers or service providers who issue tax reports to the taxpayer.

d. The Internal Tax Gap Series⁶⁹

This page contains links to monthly articles addressing the gap in the amount of tax that international taxpayers should pay as against the amount of taxes actually paid, highlighting areas of noncompliance. An article from October 2008 addresses the taxation of international pensions and annuities.

⁶⁶ Servicewide Approach to International Tax Administration (last reviewed or updated October 17, 2007) at www.irs.gov/businesses/international/article/0,,id=174834,00.html.

⁶⁷ Alien Taxation – Certain Essential Concepts (last reviewed or updated November 3, 2008) at www.irs.gov/businesses/small/international/article/0,,id=96414,00.html.

⁶⁸ Help With Tax Questions – International (last reviewed or updated November 12, 2008) at www.irs.gov/help/page/0,,id=133197,00.html.

⁶⁹ The International Tax Gap Series (last reviewed or updated April 1, 2009), at www.irs.gov/businesses/article/0,,id=180259,00.html.

2. IRS Publications

Pub. 54	Tax Guide for U.S. Citizens and Resident Aliens Abroad
Pub. 80	Circular SS - Federal Tax Guide for Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands
Pub. 513	Tax Information for Visitors to the United States
Pub. 514	Foreign Tax Credit for Individuals
Pub. 515	Withholding of Tax on Nonresident Aliens and Foreign Entities
Pub. 516	U.S. Government Civilian Employees Stationed Abroad
Pub. 519	U.S. Tax Guide for Aliens
Pub. 570	Tax Guide for Individuals with Income from U.S. Possessions
Pub. 593	Tax Highlights for U.S. Citizens and Residents Going Abroad
Pub. 678-FS	Foreign Student and Scholar Text (2007)
Pub. 901	U.S. Tax Treaties
Pub. 1187	Specifications for Filing Form 1042-S, Foreign Persons U.S. Source Income Subject to Withholding, Electronically
Pub. 1321	Special Instructions for Bona Fide Residents of Puerto Rico Who Must File a U.S. Individual Income Tax Return (Form 1040 or 1040A) (2007)
Pub. 4732	Federal Tax Information for U.S. Taxpayers Living Abroad
Pub. 4588	Basic Tax for Green Card Holders: Understanding Your U.S. Tax Obligations

EXHIBIT B. Summary of General Rules for Federal Income Tax Withholding and Reporting on Distributions to Nonresident Aliens from Qualified Pension Plans and IRAs

The nonresident alien withholding and reporting requirements, which generally are summarized below, depend upon a number of factors: the nature and source of the payment; the status of the payee – U.S. or foreign, beneficial owner or intermediary; where the payment is made (in or outside of the United States); and where the account is held (on-shore or off-shore).

A withholding agent, such as a financial institution that makes a payment of U.S. source income (which includes U.S. qualified retirement plan and IRA distributions) to a nonresident alien, is liable to the U.S. government for the amount of tax that should have been withheld, unless an exception to withholding exists.

I. Withholding from Periodic and Nonperiodic Distributions Under Code § 3405

Unless the nonresident alien is eligible for and elects no withholding under Code § 3405, the distribution is treated for federal income tax purposes as any other retirement plan distribution and withholding applies according to the type of plan (IRA, qualified retirement plan or 403(b) plan). For IRAs, withholding is at the standard 10% rate; for qualified retirement plans, the rate is either based on the nonperiodic withholding rate of 10% or the periodic withholding tables contained in Publication 15 (including the amendments reflected in Publication 15-A under the Stimulus Act of 2009). In this case, the distribution and tax withholding is reported on IRS Form 1099-R. If a distribution is made to a U.S. Person and it is an eligible rollover distribution, the taxable portion of the distribution from a qualified retirement plan or 403(b) plan is subject to 20% mandatory withholding.

II. Electing Out of Nonresident Alien Withholding under Code § 3405

- A. If a distribution is made to a nonresident alien, an election to waive the normal withholding is made by (1) filing Form W-8BEN with the payer (see “The W-8 Family of Forms” below) and (2) signing a written certification, under penalty of perjury, with the payer that the individual is not a U.S. citizen or resident alien, and is not an expatriate of the United States (one who expatriates for the principal purpose of avoiding U.S. taxes).⁷⁰

⁷⁰ Code § 3405(e)(13)(B)(i).

- B. A nonresident alien who elects out of Code § 3405 withholding is subject to withholding under Code § 1441, usually at the treaty rate or in the case of an IRA distribution normally at the rate of 30%. The distribution is reported on IRS Forms 1042-S and 1042. IRS Publication 515 (Withholding of Tax on Nonresident Aliens and Foreign Entities) contains more information about the various types of income, including retirement income, which are subject to tax withholding and explains when exemptions or reduced withholding rates apply to certain types of income.

III. Lower Treaty Rates

If a nonresident alien elects no withholding under Code § 3405 by filing Form W-8BEN and providing the statement described above, the recipient may be able to claim the treaty benefits under the country's income tax treaty with the United States. If any lower treaty rate applies (including 0%), the payments are still reportable on IRS Form 1042-S and 1042. Using the lower treaty rate is not automatic for IRAs.⁷¹

IV. The "W-8 Family of Forms"

Without proper documentation (the appropriate and valid applicable Form W-8), the 30% withholding rate applies. The IRS has issued the following withholding certificates referred to as the "W-8 Family of Forms":

Form Number	Name of Form	Information about the Form
W-8BEN	Certificate of Foreign Status of Beneficial Owner for U.S. Tax Withholding	When this form is filed with the payer, the individual is claiming to be a foreign person and is also claiming whether or not treaty benefits apply.
W-8ECI	Certificate of Foreign Person's Claim for Exemption from Withholding on Income Effectively Connected with the Conduct of a Trade or Business in the United States	In general, foreign persons are subject to U.S. tax at a 30% rate on income they receive from U.S. sources. However, no withholding is required on income that is, or is deemed to be, effectively connected with the conduct of a trade or business within the United States. and is includible in the beneficial owner's gross income for the tax year.
W-8EXP	Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding	A withholding agent may treat a payee as an international organization without requiring a Form W-8EXP if the name of the payee is one designated as an international organization by Executive Order and other facts surrounding the payment reasonably indicate that the beneficial owner of the payment is an international organization.

⁷¹ See Part V.B.6. of this report for a discussion of treaty issues.

Form Number	Name of Form	Information about the Form
W-8IMY	Certificate of Foreign Intermediary, Foreign Partnership, or Certain U.S. Branches for United States Tax Withholding	A qualified intermediary, withholding foreign partnership, or a withholding foreign trust must provide the EIN that was issued to the entity in such capacity (such as its "QI-EIN", "WP-EIN" or "WT-EIN"), or otherwise the Form W-8IMY it submits is not valid.
W-8CE	Notice of Expatriation and Waiver of Treaty Benefits	To be completed by a "covered expatriate individual" as notification to the payer that special tax rates apply. The form is required if the individual has any deferred compensation accounts.

V. Duration of Form W-8BEN Validity

A Form W-8BEN provided without a Taxpayer Identification Number (TIN) remains in effect for a period that begins on the date the form is signed and ends on the last day of the third succeeding calendar year, unless a change in circumstances makes any information on the form incorrect. For example, a Form W-8BEN signed on September 30, 2004, remains valid through December 31, 2007.

A Form W-8BEN furnished with a TIN will remain in effect until the status of the person whose name is on the form changes, or a change in circumstances makes any information on the form incorrect, provided that the withholding agent reports on Form 1042-S at least one payment annually. Thus, a Form W-8BEN containing a TIN remains valid for as long as the filer's status and the information relevant to the filer's certification on the form remains unchanged.

A TIN is either a U.S. Social Security Number (SSN) or an Individual Tax Identification Number (ITIN). An ITIN can be obtained by a nonresident alien who either does not have or is not entitled to a SSN.

The validation process of the Form W-8BEN requires establishing foreign status (using the pension presumption rules); establishing a claim for treaty benefits; and that the form is signed and dated.

VI. Claim by Nonresident Alien for a Refund of Tax Withheld

Whether the payer withholds under Code § 3405 and files Form 1099-R reporting the retirement distribution or withholds under Code § 1441 and files Form 1042-S reporting the retirement distribution, the nonresident alien can file Form 1040-NR in order to claim a refund of taxes.

VII. IRS Amends Final Nonresident Alien Regulations to Include IRAs

On May 16, 2000, the IRS published amendments⁷² to the final regulations⁷³ on the income tax withholding requirements on payments made to nonresident aliens. These amendments extended the “presumption rules” applicable to qualified retirement plans and 403(b) plans to IRAs described under Code § 408. Code § 408 includes traditional IRAs, SEP IRAs, and SIMPLE IRAs, but does not include Roth IRAs that are governed under Code § 408A. Although Code § 408 IRAs are now mentioned in the nonresident alien regulations, this does not necessarily change the resulting withholding on payments to a nonresident alien.

VIII. Presumption of Payment to a U.S. Person

Payments from a qualified plan, a 403(b) account, or a Code § 408 IRA that a withholding agent cannot reliably associate with documentation is presumed to be made to a U.S. Person **only if**: the payee has a SSN (not just an ITIN) **and** a mailing address in the United States, or in a foreign country with which the United States has an income tax treaty in effect providing that a payee who is an individual resident in that country would be entitled to an exemption from U.S. tax on retirement plan payments. In such cases, income tax is withheld at the appropriate rate under Code § 3405, depending upon the type of plan and frequency of payments, and payments are reported on IRS Form 1099-R. Any payment that does not meet the above requirements can be presumed to be made to a foreign person, in which case income tax is withheld under Code § 1441 at the treaty rate or, if none can be identified, at a rate of 30%, and the payments are reported on IRS Form 1042-S.

For purposes of the retirement plan and IRA presumption rules, a participant with an address in one of the U.S. possessions (which include American Samoa, Guam, Northern Mariana Islands, Puerto Rico and the U.S. Virgin Islands) is treated as foreign and withholding is required at the statutory 30% NRA rate.

IX. Presumption of Foreign Status by Filing Form W-8BEN

If the payer receives from the payee a completed Form W-8BEN, the withholding agent can usually presume the payee is foreign, unless the withholding agent has reason to believe that the payee is a U.S. Person. When a Form W-8BEN is received, the withholding agent applies the 30% withholding rate. However, if the payment is from a qualified plan or a 403(b) account **and** the payee either has a SSN an ITIN, the withholding agent can apply the lower treaty rate (if any) found in the tables in IRS Publication 515 (Withholding of Tax on Nonresident Aliens and Foreign Entities).

⁷² T.D. 8881, 65 Fed. Reg. 32152 (May 22, 2000), 2000-23 I.R.B. 1158.

⁷³ T.D. 8734, 62 Fed. Reg. 53387 (October 14, 1997); 1997 I.R.B. 5.

X. Lower Treaty Rates are NOT Automatic for IRAs

Unlike distributions from qualified retirement plans or 403(b) plans, in order to apply any lower treaty rates for payments from an IRA, the treaty must specifically state that IRAs are treated as “pension income.” Payers refer to IRAs being “treaty specific” for purposes of withholding under Code § 1441. Thus, If a treaty does not specifically so state or if the treaty is silent, the 30% withholding rate **cannot be reduced**, even if the payee has a SSN or ITIN. Since the payer is “responsible for the withholding,” if the withholding is incorrect, the payer - not the plan - is subject to penalties, and thus most IRA payers default to the 30% withholding rate.

XI. Glossary of Terms

A. Nonresident Alien

A nonresident alien is an individual who is not a U.S. citizen or resident. A nonresident alien is not a “resident alien.”

B. Resident Alien

A resident alien is an alien who meets either the green card test or the substantial presence test for the calendar year. IRS Publication 519 provides more information on resident and nonresident alien status, the tests for residence and the exceptions to them.

C. Individual Tax Identification Numbers

A Tax Identification Number (TIN) is either a U.S. Social Security Number or an Individual Tax Identification Number (ITIN). An ITIN can be obtained by a nonresident alien who either does not have or is not entitled to a U.S. Social Security Number.

D. Periodic Distributions

Periodic distributions are annuity-type payments scheduled over a period longer than one year, including installment payments, made from a qualified retirement plan, 403(b) plan or 457(b) plan. Periodic distributions (not subject to Code § 1441 of the Code) are subject to withholding as if such payments were wages, depending on the payment frequency (i.e., monthly, quarterly, semi-annually or annually). Therefore, the normal wage withholding tables found in Circular E are used to determine the amount to be withheld from each plan annuity or installment payment.

The individual may indicate marital status and the number of exemptions for purposes of determining the withholding amount. If the individual fails

to make such indication, the payer withholds as if the individual were married and claiming three withholding allowances.⁷⁴

If the recipient does not provide a Social Security Number or the IRS notifies the payer (before any distribution is made) that the payee's Social Security Number is incorrect, the payer must withhold as if the payee were single and claiming no withholding allowances.

E. Nonperiodic Distributions

Nonperiodic distributions are distributions that are not periodic and are made from a qualified retirement plan, 403(b) plan, 457(b) plan or IRA. Nonperiodic distributions are subject to a flat withholding rate of 10%. All distributions from IRAs are considered to be nonperiodic. The recipient may elect to have more than 10% withheld from a nonperiodic distribution.⁷⁵

F. Payments made Outside of the United States

Treasury Regulation § 1.1441-1(b)(3)(iii)(C) provides that for payments made outside of the United States from a qualified retirement plan, 403(b) plan, 457(b) plan or IRA for which a withholding agent (the payer) cannot reliably associate with documentation may be presumed to be made to a U.S. Person only if the withholding agent has a record of a SSN for the payee and relies on a qualifying mailing address. A qualifying mailing address is an address used for purposes of information reporting or otherwise communicating with the payee and is located (1) in the United States or (2) in a foreign country with which the United States has an income tax treaty in effect that provides that the payee, if an individual resident in that country, would be entitled to an exemption from U.S. tax on amounts received from a retirement qualified plan.

If the payer can presume that the recipient is a U.S. Person, withholding is made in accordance with Code § 3405. Thus, if the payment is an eligible rollover distribution (as defined under Code § 402(c)(4)), mandatory withholding applies at the rate of 20%. If the payment is not an eligible rollover distribution, the voluntary withholding rules apply (10% or the rate determined by the wage tables), including the recipient's right to waive the withholding requirement. However, pursuant to Code § 3405(e)(13)(A), the recipient is not permitted to elect no withholding if the person's address is outside of the United States or is in any U.S. possession. For payments made to a nonresident alien where the payer is withholding under Code § 3405, withholding is made as if the recipient were single and claiming one withholding allowance.

⁷⁴ Treas. Reg. § 35.3405-1, Q&A B-4.

⁷⁵ IRS Form W-4P.

Any payment from a qualified retirement plan or 403(b) plan that is not presumed made to a U.S. Person is presumed made to a foreign person. A withholding agent making a payment to a person presumed to be a foreign person may not reduce the 30% amount of withholding required under Code § 1441 on such payment unless it receives a withholding certificate.

G. Withholding Agents

A withholding agent is a person, U.S. or foreign, that has control, receipt or custody of an amount subject to withholding or who can disburse or make payments of an amount subject to withholding. A Withholding agent can be an individual, corporation, partnership, trust, association, or any other entity, including but not limited to any foreign intermediary, foreign partnership, and U.S. branches of certain foreign banks and insurance companies. In general, the person who pays (or causes to be paid) the amount subject to withholding to the foreign person (or to its agent) must withhold.

XII. Sample W-8BEN Checklist

Form W-8BEN Checklist for Pension Payments (Use for Form Validation and Determining Presumption Rules)

Presumption Rules (Determine whether Payee is U.S. or Foreign)

Presume U.S. if both of the following are valid; otherwise presume foreign.

☐ Valid U.S. SSN

Note: Treat the following as invalid SSNs – Begins with “000,” contains all zeros, ones, twos, etc., begins with a “plan number,” contains alpha characters, or begins with an “8” (an SSN cannot begin with an “8” but check EINs. If an entity is a beneficiary then EIN may begin with an “8”).

Also check for beneficiary status or QDRO account; the SSN may belong to another person or entity.

☐ U.S. Residence Address

Includes an address in the United States or an address in a foreign country that has an income tax treaty with the United States in effect that exempts that type of payment from U.S. tax. Refer to Presumption Rule Chart for Private and Government Plans. Does not include addresses in one of the U.S. possessions; treat these as foreign and withhold based on the appropriate treaty rate, or 30% if an IRA or treaty rate cannot be determined.

Withholding and Reporting

If both boxes are checked, this is a distribution being made to a U.S. Person and the normal pension withholding rules apply pursuant to Code §3405 and reporting is done on form 1099-R. **STOP, no further determination is required.**

If both boxes are not checked then the NRA withholding rules apply under Code §1441 and reporting is done on Form 1042-S.

Validation of Form W-8BEN

Part I of Form W-8BEN (Establish Foreign Status)

- ☐ Full name is indicated on Line 1 and matches the name under the pension plan.
- ☐ The "individual" box is checked, or if payment is made to a beneficiary the "complex trust" or "estate" box may be checked.
- ☐ Name and entity box information matches.
- ☐ The permanent address does not include a P.O. box or "in care of" address.
- ☐ The permanent address is a foreign address, or the permanent address is a U.S. Address but there is additional documentary evidence (written explanation is provided by payee) that would presume that the person is foreign.
- ☐ The mailing address is foreign (or the plan has a written foreign address), or the mailing address is a U.S. address but there is additional documentary evidence **and** a written explanation is provided by payee that would presume that the person is foreign.
- ☐ The distribution paperwork has a foreign address, or the distribution paperwork has a U.S. address but there is additional documentary evidence **and** a written explanation is provided by payee that would presume that the person is foreign.
- ☐ The country entered on the form must be spelled out and not abbreviated.

Part I Determination is ☐ U.S. ☐ Foreign

Part II – Establish Claim for Treaty Benefits

(Completed by NRA claiming Treaty Benefits)

- ☐ Box 9a is checked and a treaty country is listed. The treaty country must be spelled out not abbreviated.
- ☐ Permanent residence country is the same country listed in 9a or, if not the same, additional documentary evidence with an address in the treaty country **or** a written explanation is provided by the payee.
- ☐ Mailing address is in the same country listed in 9a or, if not the same, additional documentary evidence with an address in the treaty country **or** a written explanation is provided by the payee.
- ☐ Address on file for plan is in the same country listed in 9a or, if not the same, additional documentary evidence with an address in the treaty country **or** a written explanation is provided by the payee.
- ☐ If there are instructions in the plan file to pay amounts to an address outside the treaty country there is a written explanation provided by the payee.
- ☐ Box 9b is checked if a reduced rate of withholding under a treaty benefit is claimed.
- ☐ If required (check the most recent instructions for the list of countries that require line 10), line 10 is completed with the Treaty Article number, reduced treaty rate, identification of the income for which treaty benefits are being claimed (e.g., pension income), and an explanation of the reason the NRA meets the terms of the treaty article.
- ☐ Review and verify the Treaty Article cited. Payer is not required to verify if the “person” is entitled to this provision, only that the Treaty Article cited and the tax rate is correct.

Part II – Treaty Claim Country _____; Rate: _____%

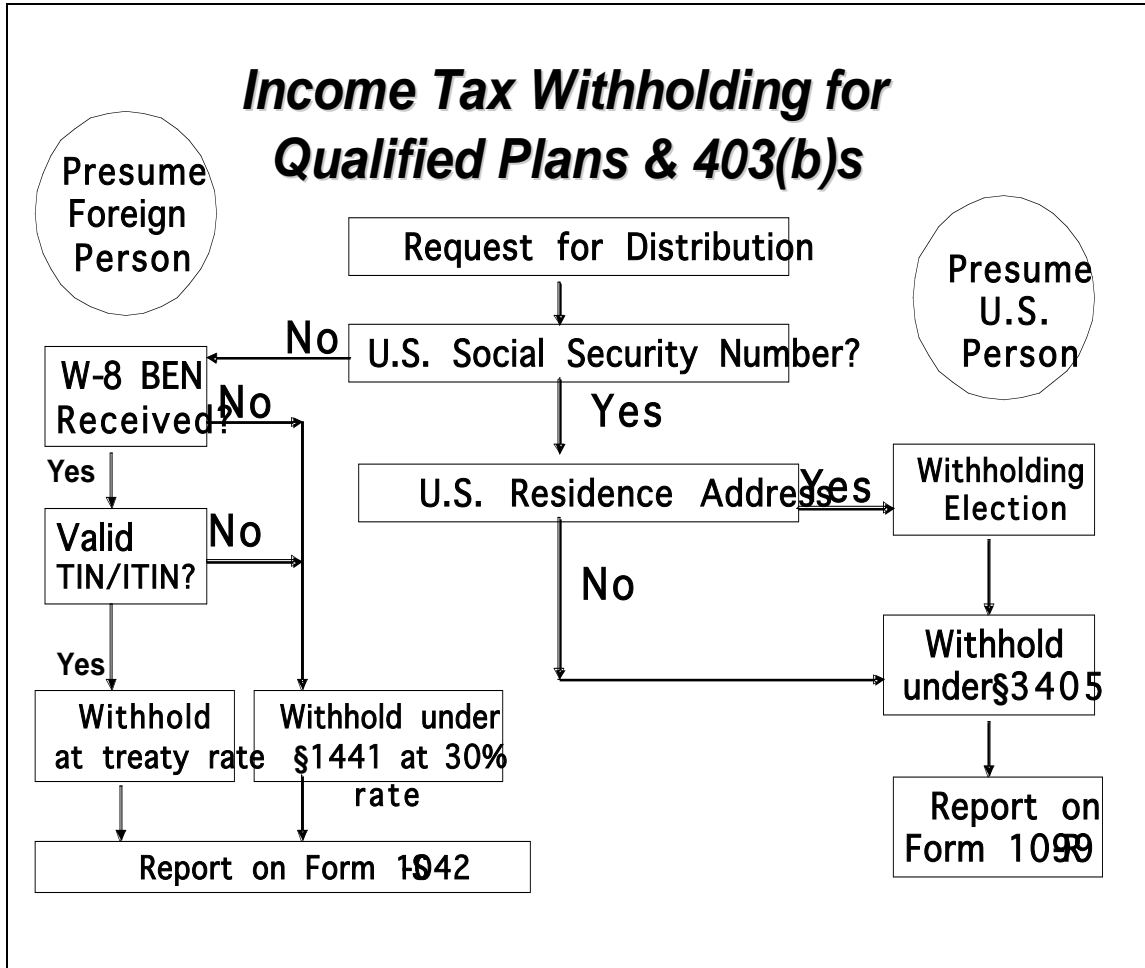
Part III - Does not apply to Pension Payments

Part IV – Signatures

- ☐ The form is signed and dated. The validity period is measured from the date entered.
- ☐ The form contains no additions, deletions or alterations. The capacity line is completed. If the capacity line indicates an agent, a Form 2848 or copy of another document authorizing the agent must be attached to this form. If neither is attached the form, the form is not valid.
- ☐ The form must be an original. No copies, faxes or substitute versions of Form W-8BEN may be used.
- ☐ The form is the most recent version of the Form W-8BEN.
- ☐ If form is not valid, determine status under the presumption rules. If there is any doubt, withhold at 30% and report on the Form 1042-S, not on a Form 1099-R.

Part IV - ☐ Completed properly and completely; ☐ Not completed properly and completely.

XIII. Sample Flowchart for Withholding and Reporting Determinations Under Presumption Rules for Foreign Persons and U.S. Persons



**EXHIBIT C. Individuals Who Provided Input for
This ACT Report**

- A. IRS Office of Associate Chief Counsel (TE/GE)**
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- B. IRS Office of Associate Chief Counsel (International)**
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G. Stakeholders

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Carl Lerner – Retired from Pfizer
David Powell, Esquire – Groom Law Group
Ken Porter – was with DuPont and now is the head of the American Benefits Council new International Committee formed in 2007
3. Consultants
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4. Benefits Counsel
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James Starshak – Carlsmith Ball, LLP, Honolulu, HI
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EXHIBIT D. BenefitsLink Survey

Survey of Employee Benefits Issues in a Global Economy; September 30, 2008, Response Date

The IRS Advisory Committee on Tax Exempt and Government Entities (TE/GE) (the "ACT") is undertaking a study to identify international and cross-border activities, issues, challenges, impediments and barriers in connection with the design, coverage, portability, and tax administration of U.S. employee retirement (qualified and non-qualified) and fringe benefit plans.

As part of this effort, the ACT is particularly interested in the views of stakeholders, such as employers, administrators, trustees, custodians, practitioners and consultants regarding these issues.

While all input is welcome, the ACT is particularly interested in the challenges, barriers, and concerns, in connection with the following categories:

- (1) U.S. employee benefit plans covering employees working outside of the United States, whether expatriates, seconded employees, leased employees, non-resident aliens or others with U.S. and/or foreign compensation.
- (2) U.S. employee benefit plans covering foreign nationals, green card holders, resident aliens, or others on temporary visas or assignments (such as clergy, ambassadors, speakers) working in the United States.
- (3) Coverage issues, such as controlled groups and separate lines of business, compensation definitions and discrimination testing, involving U.S. subsidiaries with foreign parents or U.S. companies with foreign operations.
- (4) Reporting, withholding and other special issues relating to Puerto Rico and other U.S. possessions and territories, after Rev. Rul. 2008-40.
- (5) Reporting and withholding on contributions and distributions, double taxation, treaties, rollovers and other tax related issues.

To shape the direction of the ACT's further analysis and recommendations, we would appreciate your input by September 30, 2008. In the space provided below, please enter all information that you feel would be helpful. If you would be willing to participate in further discussion by conference call or attend a stakeholders' meeting in Washington, DC, in October 2008 or January 2009, please indicate your interest and provide contact information.

After you have entered your comments below (in this Microsoft Word document), please send the revised document to the ACT **on or before October 22, 2008**, by emailing it to actsurvey@penserv.com

As members of the ACT, we greatly appreciate your assistance with this project.

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Please enter comments below – no limit as to length; include as many pages as you'd like -- and send the revised document to 4 or before October 22, 2008.

Thank you!

**EXHIBIT E. Specimen for IRS Publication and/or
Posting on IRS Website**

U.S. Tax-Qualified Retirement Plans: Cross-Border Transactions

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U.S. Tax-Qualified Retirement Plans: Cross-Border Transactions

I. Introduction

This primer addresses the U.S. income tax consequences for (1) U.S. citizens or resident aliens who remain covered under a U.S. tax-qualified retirement plan (“U.S. qualified plan”) even though they have been transferred to work in another country (“outbound workers”) and (2) nonresident aliens who are transferred from another country to work in the United States and are covered by a U.S. qualified plan (“inbound workers”).⁷⁶ For purposes of this discussion, all employer plans are included (Code § 401(a) qualified plans, 403(b) plans and 457(b) plans) in the reference to U.S. qualified plans.

After discussing the eligibility of these workers to participate in a U.S. qualified plan, other issues are presented based on the plan’s four basic income tax advantages:

- The employer can currently deduct contributions to the plan;
- The workers are not currently taxed on the contributions to the plan or, in the case of defined benefit plans, benefits that accrued under the plan;
- The trust or other funding vehicle (e.g., group annuity contract) is not taxed on investment earnings that accumulate under the plan; and
- The workers are generally taxed when they receive distributions from the plan, although the distributions may be entitled to further favorable income tax treatment (e.g., tax-free rollover to an IRA (individual retirement arrangement)).

Each of these four tax advantages are conditioned upon the U.S. qualified plan’s compliance with numerous requirements in the Internal Revenue Code of 1986, as amended (the “Code”). However, this primer focuses on those U.S. requirements that apply to cross-border transactions involving outbound and inbound workers, including illustrations of the requirements under bilateral income tax treaties with foreign countries.

Although the focus is on U.S. requirements, the primer also discusses conceptually similar foreign law requirements that might apply to outbound and inbound workers covered by U.S. qualified plans.

⁷⁶ For a more detailed analysis of these and other international transactions (*e.g.*, covering outbound workers in a foreign retirement plan), see Hall, Woyke & Klein, *International Pension Planning* (2003) (Tax Management Portfolios 320-2nd).

II. Outbound Workers

A. Eligibility to Participate

1. Exclusive Benefit Rule

A U.S. qualified plan must be maintained for the exclusive benefit of employees of the employer sponsoring the plan.⁷⁷ Thus, it would initially appear that a U.S. qualified plan could not cover an employee transferred to a foreign country to work for an affiliated employer without including all employees of such affiliate. Of course, the exclusive benefit rule would not create a problem if the employer sponsoring the plan merely opens a branch—in contrast to creating a subsidiary or other separate business entity—in the foreign country.

2. Code §§ 406 and 407 – Foreign Affiliates and Domestic Subsidiaries

Prior to ERISA and the addition of Code §§ 414(b) and (c), the problem created by the exclusive benefit rule was initially addressed by Code §§ 406 and 407, which were added to the Code in 1963. Code § 406 enables an American employer⁷⁸ to treat U.S. citizens or resident aliens employed by its foreign affiliate⁷⁹ as its employees for tax-qualification purposes if certain conditions are met. Similarly, Code § 407 enables a parent corporation with a domestic subsidiary⁸⁰ doing business outside the United States to treat U.S. citizens or resident aliens employed by its domestic subsidiary as its employees if certain conditions are met.

Code § 406 Conditions. Code § 406 imposes the following conditions:

- The U.S. qualified plan document must expressly cover U.S. citizens or resident aliens working for a foreign affiliate.
- Contributions cannot be made to another funded plan for these workers, even if it is not a U.S. qualified plan, with respect to their compensation from the foreign affiliate.

⁷⁷ Code § 401(a).

⁷⁸ Code § 406 defines an “American employer” by reference to Code § 3121(h). For a corporation, it means being organized under the laws of the United States or of any state. See discussion of Code §§ 414(b) and (c) under II.A.3.

⁷⁹ A “foreign affiliate” is a foreign entity in which the American employer owns a 10% or more interest. Code § 406 incorporates this definition by reference to Code § 3121(l)(6). Code § 406 would be available to a U.S. subsidiary of a foreign parent corporation only in the highly unlikely event that the U.S. subsidiary owned a 10% or more interest in the foreign parent corporation.

⁸⁰ Code § 407(a)(2) requires a U.S. parent corporation to own at least 80% of the domestic subsidiary’s voting stock. Also, at least 95% of the domestic subsidiary’s gross income over a three-year period must be derived from sources outside the United States.

- A Code § 3121(l) Social Security agreement must cover the U.S. citizens or resident aliens working for the foreign affiliate.⁸¹
- The U.S. qualified plan must cover all the U.S. citizens and resident aliens covered under the Social Security agreement.

Under a Social Security coverage agreement, an American employer can agree to cover U.S. citizens and resident aliens under Social Security, even if they are working for a foreign affiliated employer in a foreign country. With respect to each foreign affiliate, however, the American employer can choose only to cover either none or all of these workers under a Social Security coverage agreement.⁸² As a result, Code § 406 does not allow an American employer to select which U.S. citizens or resident aliens to cover under its U.S. qualified plan. If the foreign affiliate is covered under a Social Security coverage agreement, then § 406 requires the U.S. qualified plan to cover all of its U.S. citizens and resident aliens.

Code § 407 Conditions. Code § 407 imposes the following conditions:

- The U.S. qualified plan must expressly cover U.S. citizens or resident aliens working for the domestic subsidiary doing business in a foreign country;
- Contributions cannot be made to another funded plan for these workers, even if it is not a U.S. qualified plan, with respect to their compensation from the domestic subsidiary; and
- The U.S. qualified plan must cover all the U.S. citizens or resident aliens working for each domestic subsidiary.

The Code § 407 regulations explicitly require that the U.S. qualified plan apply to every domestic subsidiary of the U.S. parent.⁸³ Thus, Code § 407 does not allow the U.S. parent corporation to select the U.S. citizens or resident aliens working for domestic subsidiaries who will be covered under its U.S. tax qualified retirement plan.

Because of the Code §§ 406 and 407 restrictive conditions, many employers comply with the exclusive benefit rule by relying on the controlled group rules under Code §§ 414(b) and (c), which do not impose similar conditions.

⁸¹ If the United States has a Social Security totalization agreement with the foreign country where the foreign affiliate is doing business, Social Security taxes are paid only to one country.

⁸² A Social Security coverage agreement is filed using IRS Form 2032.

⁸³ Treas. Reg. 1.407-1(b)(1)(i).

3. Code §§ 414(b) and (c) – Controlled Group Rules

Code §§ 414(b) and (c) controlled group rules were enacted in 1974 primarily to supplement the nondiscrimination rules for U.S. qualified plans. Nevertheless, Code § 414 became another solution to the exclusive benefit rule because:

- Code §§ 414(b) and (c) treat all employees of the members of a controlled group as if they were employed by a single employer when applying the nondiscrimination rules and certain other tax-qualification rules, including the exclusive benefit rule.⁸⁴
- Foreign members can be part of an employer's controlled group.⁸⁵

Relying on Code §§ 414(b) and (c), instead of Code §§ 406 or 407, enables a U.S. qualified plan to selectively cover U.S. citizens or resident aliens working in a foreign country as long as the selective coverage does not violate the nondiscrimination rules or applicable minimum standards (e.g., minimum participation standard under Code § 401(a)(26)). However, the nondiscrimination rules and minimum standards apply on a controlled group basis (i.e., all employees of the controlled group are treated as employed by a single employer). Thus, if a U.S. qualified plan would otherwise satisfy these requirements on a controlled group basis, the plan will continue to satisfy these requirements in the vast majority of cases, even if U.S. citizens or resident aliens working in a foreign country are selectively covered.

As suggested by the plan document requirement under Code §§ 406 and 407, the plan document for a U.S. qualified plan relying on the controlled group rules to satisfy the exclusive benefit rule must accurately describe the U.S. citizens or resident aliens working in a foreign country who are covered by the plan. Otherwise, the plan will fail the most basic tax-qualification requirement—it must be administered in accordance with the terms of the plan document.

4. Code § 414(n) – Leased Employees

Another solution to the exclusive benefit rule is a leasing arrangement under which the U.S. citizens or resident aliens working in a foreign country remain employees of the U.S. employer but are leased to the employer in the foreign country.

⁸⁴ In Private Letter Ruling 8228116 (April 19, 1982), the IRS ruled that a parent corporation's U.S. qualified plan could cover nonresident aliens employed by one of its foreign subsidiaries that was part of the parent corporation's controlled group. In Private Letter Ruling 8144028 (August 4, 1981), the IRS ruled that a U.S. qualified plan could selectively cover certain highly compensated nonresident alien employees not earning U.S. source income.

⁸⁵ In *Fujinon Optical, Inc. v. Commissioner*, 76 T.C. 499 (1981), the U.S. Tax Court ruled that a U.S. subsidiary's qualified plan discriminated in favor of highly compensated employees, even though it covered all employees satisfying the plan's minimum age and service requirements, because employees of other U.S. subsidiaries of the same foreign parent were excluded from the plan.

Technically, Code § 414(n) would require the foreign employer to treat these workers as employees not only of the U.S. employer but also of the foreign employer in determining whether the foreign employer's U.S. qualified plan, if any, discriminates in favor of its highly compensated employees. Because the foreign employer is highly unlikely to sponsor a U.S. qualified plan, however, the foreign employer's treatment of the leased workers as employees for tax-qualification purposes is almost irrelevant. The important point is that the leased worker remains an employee of the U.S. employer for exclusive benefit rule purposes.

Under Code § 414(n), a worker would be a leased employee of the foreign employer if the worker is not a common law employee of the foreign employer and all three parts of the following test are satisfied:⁸⁶

- The worker performs services for the foreign employer pursuant to an agreement between the foreign employer and the U.S. employer;
- The worker performs services for the foreign employer on a substantially full-time basis for at least one year; and
- The worker is subject to the primary direction or control of the foreign employer.

A worker would be treated as a common law employee of the foreign employer if the foreign employer has the right to direct and control the worker's activities.⁸⁷ Thus, the U.S. employer must retain in the leasing agreement the right to discharge the worker and the right to direct and control the worker's activities, subject to the foreign employer's contractual right under the leasing agreement to direct and control the worker's activities.

It should be noted, however, that a leasing arrangement could create a foreign law compliance problem if the foreign country where the leased worker is performing the services determines that the U.S. employer is doing business in the foreign country. Thus, a leasing arrangement might require the U.S. employer to comply with the foreign country's rules for doing business in the country.

5. Definition of "Compensation"

When a U.S. qualified plan is amended to address the eligibility of U.S. citizens and resident aliens working for an employer in a foreign country to participate in the plan, the plan document should also address the compensation of these workers that will be taken into account in operating the plan. Recently published regulations under Code § 415 clarify that compensation paid to a worker for services performed outside the United States can be compensation for Code § 415 purposes, even though the

⁸⁶ Code § 414(n)(2).

⁸⁷ Rev. Rul. 87-41, 1987-1 C.B. 296 (January 1987).

compensation is not included in the worker's U.S. gross income on account of the location of the services.⁸⁸

The critical issue is how the U.S. qualified plan defines compensation for benefit calculation purposes. The definition of compensation could take into account foreign housing subsidies, cost of living allowance or similar compensation elements. The question is whether the plan's compensation definition should include all or any of these compensation elements.

If the U.S. citizens or resident aliens working for an employer in a foreign country are paid in that country's currency, then the timing of conversion of the compensation to U.S. dollars is also an issue. The plan document should specify that the currency conversion will be as of a specified date during the year in which the compensation is earned (e.g., December 31), not when contributions are made to a defined contribution plan or when benefits are calculated under a defined benefit plan.

B. Employer Tax Deduction

Several methods are available for a U.S. qualified plan to cover U.S. citizens or resident aliens working in a foreign country for an employer not sponsoring the plan. However, whether employer contributions to these employee plans can be deducted and which entity is entitled to the deduction are issues separate from the issue of whether these workers are eligible to participate in the U.S. qualified plan.

As a general rule, an employer cannot deduct compensation paid on behalf of an employee of another employer, even if both employers are members of the same controlled group.⁸⁹ The following discussion explains the conditions imposed on the exceptions to the general rule.⁹⁰

⁸⁸ Treas. Reg. § 1.415(c)-2(g)(5) Foreign Compensation, published at 72 Fed. Reg. 16877, 16918-16919 (April 5, 2007). However, the Code § 415 regulations do not authorize salary reduction for Code § 401(k) purposes. Thus, a 401(k) plan sponsor would have to make contributions on behalf of the U.S. citizens or resident aliens working for a foreign employer. Also, 415 compensation for 403(b) plan purposes is limited to includible compensation under Code § 403(b).

⁸⁹ In *Transamerica Corp. v. United States*, 7 Cl. Ct. 119 (1984), the U.S. Court of Claims held that a parent corporation could not deduct stock option compensation paid to an employee of its subsidiary. In *Young & Rubicam, Inc. v. United States*, 187 Cl. Ct. 635 (1969), the court held that an employer could not deduct salaries and other related compensation (*e.g.*, profit sharing plan contributions) paid for workers temporarily transferred to its foreign subsidiaries for six months to two years.

⁹⁰ If the U.S. citizens or resident aliens working in a foreign country are leased to the employer in the foreign country but remain employees of the U.S. employer, then the U.S. employer is permitted to deduct contributions made on behalf of the leased employees.

1. Code § 406 – Foreign Affiliates

Code § 406(d) allows the foreign affiliate, not the U.S. employer, to deduct the contributions made on behalf of the U.S. citizen or resident employees working for the foreign affiliate, even though the U.S. employer actually makes the contribution to the U.S. qualified plan. Thus, the deduction is valuable only if the foreign affiliate is subject to U.S. income taxes (e.g., because it has U.S. source income).

2. Code § 407 – Domestic Subsidiaries

Code § 407(d) also allows the domestic subsidiary doing business in a foreign country, rather than the U.S. employer, to deduct the contributions made on behalf of U.S. citizen or resident aliens working for the domestic subsidiary, even though the U.S. employer actually makes the contribution to the U.S. qualified plan. Unlike the § 406 deduction, however, the domestic subsidiary can apply the deduction, regardless of its source of income.

3. Code § 414(b) and (c) – Controlled Group Rules

The controlled group rules under Code § 414(b) and (c) do not allow one member of a controlled group to deduct contributions to U.S. qualified plan made on behalf of another member of the controlled group.⁹¹ The controlled group principle that treats all employees of the members of a controlled group as if they were employed by a single employer does not apply to the deductibility of plan contributions.

The Code § 406 regulations suggest that the contributing parent corporation making the nondeductible contribution can treat the plan contribution as a contribution to capital to the extent those plan contributions are not reimbursed.⁹² If the parent corporation is reimbursed by the subsidiary employing the workers on whose behalf the plan contributions are made, then the parent corporation has no income tax consequences. The subsidiary generally is permitted to deduct the reimbursement to the contributing employer as a compensation expense.⁹³

⁹¹ Code §§ 414(b) and (c) specifically exclude their applicability to Code § 404. Code § 404(a)(3)(B) does allow a member of an affiliated group to deduct contributions on behalf of an unprofitable member of the affiliated group, if that member's contributions are contingent upon current or accumulated profits. This minor exception proves the general rule.

⁹² Treas. Reg. § 1.406-1(e)(3) (“[A]n unreimbursed contribution by the domestic corporation to a plan which meets the requirements of section 401(a) will be treated, to the extent each employee's rights to the contribution are nonforfeitable, as a contribution of capital to the foreign subsidiary to the extent that such contributions are made on behalf of the employees of such subsidiary.”).

⁹³ Rev. Rul. 84-68, 1984-1 C.B. 3 (January 1984) (“Because the parent's payment of cash bonuses to its subsidiary's employees is treated as a contribution to the subsidiary's capital accompanied by constructive payment by the subsidiary of the cash bonuses to its employees, the cash bonuses may be deducted by the subsidiary under section 162 of the

4. Excise Tax on Nondeductible Contributions

Code § 4972 imposes a 10% excise tax on an employer making contributions in excess of the amount allowable as a deductible contribution to a U.S. qualified plan. However, the IRS has ruled that this 10% excise tax does not automatically apply to employers making nondeductible contributions to a U.S. qualified plan for U.S. citizens or resident aliens working in a foreign country for an employer not sponsoring the plan.⁹⁴ According to the ruling, the 10% excise tax is focused not on nondeductible contributions but on contributions exceeding the deductible limit (*i.e.*, the amount allowable as a deduction). Thus, if the nondeductible contributions do not exceed the deductible limit (assuming the nondeductible contributions were deductible), then the 10% excise tax does not apply.

C. Employee Taxation on Contributions or Accruals

U.S. citizens or resident aliens working in a foreign country for an employer not sponsoring a U.S. qualified plan, but covered by a U.S. affiliate's qualified plan, will not be currently taxed in the United States on contributions under a defined contribution plan or on accruals under a defined benefit plan. However, the foreign country may impose income taxes on these workers for the contributions or accruals under the U.S. qualified plan.

Some U.S. bilateral income tax treaties with foreign countries provide relief for these workers from foreign income taxes on contributions and accruals under the U.S. qualified plan. For example, the 2004 U.S.-France Income Tax Treaty⁹⁵ provides that contributions or accruals under the U.S. qualified plan are not taxable to the employee in France. However, the income tax relief in France is limited to the amount that could be contributed under a "generally corresponding" French retirement plan. The relief is also conditioned upon the employee participating in the U.S. qualified plan before working in France. Article 19 of the 2006 Model Income Tax Treaty has similar provisions.⁹⁶

Code . . ."). Revenue Ruling 84-68 relies on *Anderson v. Commissioner*, 67 T.C. 522 (1976), *aff'd* 583 F.2d 953 (7th Cir. 1978).

⁹⁴ Private Letter Ruling 200211050 (December 19, 2001).

⁹⁵ See Paragraph 2 of revised Article 18 as stated in the Protocol Amending the Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital ("2004 U.S.-France Tax Treaty"), Article III (restating Article 18 of the 1994 U.S.-France Income Tax Treaty in its entirety). The 1994 U.S.-France Income Tax Treaty, the 2004 U.S.-France Tax Treaty, and their technical explanations are available at <http://www.irs.gov/businesses/international/article/0,,id=169505,00.html>.

⁹⁶ United States Model Income Tax Convention of November 15, 2006 ("2006 Model Income Tax Treaty"). The model treaty and its technical explanation are available at <http://www.irs.gov/businesses/small/international/article/0,,id=164686,00.html>.

D. Tax-Free Investment Earnings for Trusts

1. Domestic Trusts

Code § 401(a) requires that the trust for a U.S. qualified plan be maintained in the United States as a domestic trust.⁹⁷ In order to be considered a domestic trust, Code § 7701(a)(30)(E)—defining a domestic trust—requires that a U.S. court have jurisdiction over the trust.

The status of a trust as domestic or foreign becomes an issue when a trust has individuals as trustees and one or more of them are not U.S. citizens, or where one or more fiduciaries with control over the appointment of an institutional trustee, such as members of the plan sponsor's board of directors, are not U.S. citizens. In these situations, the "control" test in Code § 7701(a)(30)(E) may not be met because the U.S. trustees may not be able to "control all substantial decisions" of the trust.⁹⁸

2. Investment Earnings of Domestic Trusts

The tax-free treatment of investment earnings on plan assets held in trust for a U.S. qualified plan is not affected by covering U.S. citizens or resident aliens working in a foreign country for an affiliated employer not sponsoring the plan but covered by a U.S. affiliate's qualified plan. As explained below, however, the U.S. income tax treatment of those investment earnings when distributed will vary depending on where the U.S. citizen or resident alien resides when the U.S. qualified plan makes a distribution.

3. Foreign Country Taxation

A separate issue is whether the foreign country will impose income tax on the U.S. citizens or resident aliens for their share of the U.S. qualified plan's investment earnings. For example, the 2004 U.S.-France income tax treaty provides relief in France only for U.S. citizens or resident aliens working in France that do not obtain citizenship or immigrant status in France.⁹⁹

⁹⁷ See *also* Treas. Reg. § 1.401-1(a)(3)(i) ("a qualified trust under section 401(a) . . . must be created or organized in the United States . . . and it must be maintained at all times as a domestic trust in the United States . . .").

⁹⁸ Treas. Reg. § 301.7701-7(d)(1)(iv) ("[T]he trusts . . . are deemed to satisfy the control test . . . provided that United States trustees control all of the substantial decisions made by the trustees of the trust . . .").

⁹⁹ See Department of the Treasury Technical Explanation of the Protocol Between the United States of America and the French Republic Signed at Washington on December 8, 2004, available at <http://www.irs.gov/businesses/international/article/0,,id=169505,00.html>. The Technical Explanation describes Article 18's relationship to other articles and provides an example going in the other direction: "[A] U.S. resident (who is not a citizen or a green card holder) who is a beneficiary of a French pension plan will not be subject to tax in the United States on the earnings and accretions of, or the contributions made to, a French exempt pension trust with respect to that U.S. resident."

E. Employee Taxation on Distributions

1. Background

If U.S. citizens or resident aliens working in a foreign country for an employer not sponsoring a U.S. qualified plan, but covered by a U.S. affiliate's qualified plan, return to the United States before the plan makes distributions to them, no special issues arise regarding the income tax treatment of their distributions. However, if they are residing in a foreign country when the distributions are made, special rules apply.¹⁰⁰

Regardless of where they reside, U.S. citizens and resident aliens are generally taxed in the United States on their worldwide income (i.e., regardless of whether the source of the income is within or outside the United States). Thus, qualified plan distributions to U.S. citizens and resident aliens are potentially subject to double taxation—in the United States and in the foreign country of residence at the time of the distribution.

2. Treaties

Some U.S. bilateral income tax treaties with foreign countries provide relief from foreign income taxes. For example, the 2004 U.S.-France income tax treaty¹⁰¹ provides that distributions from a U.S. qualified plan are taxable only in the United States. This relief applies to both periodic and lump sum payments. On the other hand, many other income tax treaties provide relief from double income taxation by allowing only the foreign country where such U.S. citizens or resident aliens reside to impose the income tax.¹⁰²

3. Withholding

Code § 3405(a)(2) generally allows U.S. citizens and resident aliens to elect out of withholding on retirement plan distributions. However, Code § 3405(e)(13) specifically bars the election for any distribution delivered outside the United States. The bar is lifted only if the recipient of the distribution certifies to the payer that (a) the recipient is not a U.S. citizen or is not a resident alien of the United States or (b) the recipient is not a nonresident alien expatriated from the United States to avoid taxes as described in Code § 877.

Consistent with Code § 3405(a)(2), Form W-4P¹⁰³ allows U.S. citizens, resident aliens, or their estates who are recipients of retirement plan distributions to elect out of withholding or to specify the amount of withholding. The Form W-4P

¹⁰⁰ These special rules will also apply if these U.S. citizens or resident aliens never left the United States until they moved to another country and then begin receiving distributions from the plan.

¹⁰¹ See Article 18, Paragraph 1, as amended and restated in the 2004 U.S.-France Income Tax Treaty, Article 3, Paragraph 1.

¹⁰² See 2006 Model Income Tax Treaty, Article 17, Paragraph 1.

¹⁰³ Withholding Certificate for Pension or Annuity Payments.

instructions¹⁰⁴ reflect the Code § 3405(e)(13) bar on distributions delivered outside the United States and the treatment of nonresident aliens:

Unless you are a nonresident alien, withholding (in the manner described above) is required on any periodic or nonperiodic payments that are delivered to you outside the United States or its possessions. . . A foreign person should submit Form W-8BEN, Certificate of Foreign Status of Beneficiary Owner for United States Tax Withholding, to the payer before receiving any payments.

As explained below, nonresident aliens are subject to the Code § 1441 withholding rules, not the Code § 3405 withholding rules. Nonresident aliens would file the Form W-8BEN¹⁰⁵ or Form 8233¹⁰⁶ to claim relief from the Code § 1441 withholding rules, for example, if a tax treaty exempts their retirement plan distributions from income and withholding taxes.¹⁰⁷

III. Inbound Workers

A. Eligibility to Participate, Employer Tax Deduction, Employee Taxation on Contributions or Accruals, and Tax-Free Investment Earnings for Trust

The host of issues identified in the previous section for outbound workers do not generally apply to inbound workers because they are employees of the employer sponsoring the U.S. qualified plan, even though they are foreign nationals instead of U.S. citizens or resident aliens. For example, their eligibility to participate¹⁰⁸ in a U.S. qualified plan and their employer's ability to deduct contributions to the plan generally will not create issues. The foreign nationals also need not be concerned about U.S. income taxes either on (1) the contributions to a defined contribution plan or accruals under a defined benefit plan or (2) the plan's investment earnings.

Foreign nationals potentially have a concern about their foreign country imposing income taxes on their contributions or accruals or their share of the plan's investment earnings. However, the foreign nationals may be eligible for income

¹⁰⁴ See Page 4 of 2009 Form W-4P.

¹⁰⁵ Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding.

¹⁰⁶ Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual.

¹⁰⁷ The Form W-4P instructions suggest that the recipient of a retirement plan distribution who files a Form W-8BEN would be certifying that the recipient is not a U.S. citizen or is not a resident alien of the United States. The Form W-4P instructions do not address the other certification available under the statute (i.e., the recipient is not a nonresident alien expatriated from the United States to avoid taxes as described in Code § 877). The Form W-4P instructions seem to make the prior guidance in Notice 87-7, 1987-C.B. 420, obsolete.

¹⁰⁸ Without any adverse effect under the nondiscrimination rules, Code § 410(b)(3)(C) allows a U.S. qualified plan to exclude nonresident aliens working outside the United States. The plan's eligibility provisions should be reviewed to ensure that nonresident aliens working in the United States are not also excluded.

tax relief in their foreign country under an income tax treaty with the United States. This would be the reciprocal income tax relief under the same treaty provisions explained above for outbound workers.

B. Employee Taxation on Distributions

The employee tax treatment for distributions from a U.S. qualified plan to foreign nationals is different and more complex than distributions to U.S. citizens or resident aliens. When foreign nationals return to their foreign country, they become nonresident aliens from the U.S. point of view (unless they continue to hold a green card). The following discussion addresses the issues raised by distributions to these nonresident aliens.

1. U.S. Source Income

Code § 861(a)(3) states that compensation earned by a nonresident alien while working within the United States is U.S. source income.¹⁰⁹ Based on Code § 861(a)(3), the IRS has ruled that the portion of a plan distribution attributable to employer contributions earned by a nonresident alien while working within the United States is U.S. source income.¹¹⁰ The IRS has also ruled that the portion of a plan distribution representing investment earnings is U.S. source income, even if the entire plan distribution is attributable to employer contributions earned by the nonresident while working outside the United States.¹¹¹

2. Effectively Connected Income

The portion of a distribution attributable to employer contributions is “effectively connected” to the United States and, therefore, is generally subject to the Code § 1 graduated income tax rates, as provided in Code § 871(b). However, the portion of the distribution attributable to investment earnings is “not effectively connected” to the United States and, thus, is generally subject to the Code § 871(a) 30% flat rate tax.¹¹²

Code § 864(c)(6) states that income is effectively connected to the United States in the year that it is received if it would have been effectively connected to the United States in the year to which it is attributable. Thus, a plan distribution received by a nonresident alien that is attributable to employer contributions earned for services he performed within the United States is effectively connected in the year received. This rule applies even if the nonresident alien is no longer performing services in the United States.¹¹³

¹⁰⁹ Conversely, Code § 862(a)(3) states that compensation earned by a nonresident alien working outside the United States is not U.S. source income.

¹¹⁰ Rev. Rul. 56-82, 1956-1 C.B. 59 (January 1956).

¹¹¹ Rev. Rul. 56-125, 1956-1 C.B. 627 (January 1956); Rev. Rul. 79-388, 1979-2 C.B. 270 (July 1979); Rev. Rul. 79-389, 1979-2 C.B. 281 (July 1979).

¹¹² Private Letter Ruling 8904035 (October 31, 1988).

¹¹³ *Id.*

3. Sourcing Rule for Defined Benefit Plan Distributions

Revenue Procedure 2004-37 provides guidance on determining the source of a defined benefit plan distribution to a nonresident alien.¹¹⁴ First, the guidance describes how to determine the total amount of employer contributions deemed to have been made on behalf of a plan participant. It then describes how to apportion those contributions to services performed outside the United States. Finally, it states that the distribution is U.S. source income to the extent the amount is not attributable to employer contributions for services performed outside of the United States.¹¹⁵

The total amount of contributions is based primarily on the number of years that a nonresident has participated in the plan and the present value of the plan participant's pension on the annuity starting date. If the pension is paid as a lump sum, the present value is the lump sum amount. If the pension is paid in the form of a straight life annuity, a table is used to determine the present value. If the pension is not paid as a lump sum or straight life annuity, the present value is determined on the annuity starting date based on a 7% interest rate and the mortality rate in Revenue Ruling 2001-62.

Once total employer contributions have been determined, the procedure apportions the contributions to service performed outside of the United States based on the ratio of the number of months credited under the plan for services performed outside of the United States to the total number of months of credited service under the plan. A special adjustment applies to distributions from defined benefit plans that are partially funded with after-tax employee contributions.

Conspicuous by its absence from the procedure is guidance for determining the portion of a distribution that is effectively connected with the United States. By failing to provide this guidance, the IRS is effectively requiring withholding¹¹⁶ at the 30% flat rate for both employer contributions for services performed within the United States and the investment earnings, rather than allowing withholding at the graduated income tax rates for the portion of the distribution constituting effectively connected income because it is attributable to employer contributions for service within the United States

¹¹⁴ Rev. Proc. 2004-37, 2004-26 I.R.B. 1099 (June 28, 2004).

¹¹⁵ The IRS has not published guidance for defined contribution plans, presumably because tracing the sources (*i.e.*, investment earnings and contributions for resources within and outside the United States) is more administratively practicable for a defined contribution plan than for a defined benefit plan.

¹¹⁶ The withholding rules for distributions to nonresident aliens are discussed below.

4. Annuity Distributions

If a nonresident alien receives a distribution from a U.S. qualified plan in the form of an annuity, Code § 871(f) states the distribution to a nonresident alien is excludable from gross income if:

- 90% or more of the employees under the plan are U.S. citizens or residents at the time the distribution begins, and
- The benefits are attributable to services that were either:
 - performed outside the United States by a nonresident alien, or
 - performed within the United States for a foreign employer by a nonresident alien who was temporarily present in the United States for a period (or periods) not exceeding 90 days during the taxable year and whose compensation for such services did not exceed \$3,000.

5. Income Tax Treaty Relief

Many U.S. bilateral income tax treaties provide relief from double income taxation by allowing only the foreign country where the nonresident alien resides to impose an income tax on distributions from U.S. qualified plans.¹¹⁷ Thus, nonresident aliens returning to their foreign country with such a treaty would not be subject to U.S. income tax on their U.S. qualified plan distributions.

6. Withholding and Rollovers

Code § 1441 generally requires payers to withhold the 30% (or the treaty rate, if less) of income payable to nonresident aliens. As a result, distributions from U.S. qualified plans are subject to withholding under Code § 1441.¹¹⁸ Indeed, the Code § 1441 regulations¹¹⁹ explicitly state that Code § 3405 does not apply to any distribution subject to withholding under Code § 1441.

The entire distribution from a U.S. qualified plan to a nonresident alien is subject to 30% (or the treaty rate, if less) withholding, even if a portion of the distribution is attributable to employer contributions for services within the United States and, thus, effectively connected to the United States and subject to U.S. graduated income tax rates. As result, if a nonresident alien's graduated income tax rate is

¹¹⁷ See 2006 Model Income Tax Treaty, Article 17, Paragraph 1.

¹¹⁸ Pursuant to Code § 1441(c)(4), IRS regulations exempt from 30% withholding compensation for services that is "effectively connected" to the U.S. In addition, regulations that applied prior to 2001 allowed a nonresident alien to elect withholding under the graduated income tax rates to avoid the 30% flat tax rate withholding, even though only the portion of the distribution attributable to employer contributions for services within the United States was effectively connected to the United States. See Preamble to Proposed Treas. Reg. § 1.1441-4, 61 Fed. Reg. 17614 (April 22, 1996) (discussing Treas. Reg. § 1.1441-4T(b)(ii)).

¹¹⁹ Treas. Reg. § 1.1441-4(b)(1)(ii).

lower (or higher) than the 30% flat withholding rate, the nonresident alien must file Form 1040 NR¹²⁰ to claim a refund (or pay additional tax).

If a nonresident alien qualifies for U.S. income tax relief, or a reduced U.S. income tax rate, under a treaty, then the nonresident alien must file Form 8233¹²¹ with the plan administrator to claim an exemption from U.S. income tax withholding. If the nonresident alien is claiming an annuity distribution is exempt from U.S. income tax under Code § 871(f), the nonresident alien must file Form W-8BEN¹²² with the plan administrator. Form W-8BEN should also be filed instead of Form 8233 when a distribution is subject to U.S. income tax solely because of the investment earnings (*i.e.*, no portion of the distribution is attributable to employer contributions for services within the United States).

A distribution from a U.S. qualified plan is subject to the 30% flat withholding rate if the recipient does not have a U.S. social security number for the recipient or if the recipient's address is in a foreign country without an income tax treaty that would exempt the distribution from U.S. income tax.¹²³

Nonresident aliens can elect to rollover eligible distributions to an IRA and avoid income taxation and the 30% withholding under Code §§ 3405 and 1441 if certain requirements are met. The rationale for the ruling is:

The primary reason for imposing withholding tax at the source on distributions to NRAs and U.S. citizens abroad is that it may be difficult or impossible to collect the tax once the income is out of the United States. This concern is addressed, however, if a qualified plan distribution is rolled over to an IRA. An IRA must be established in the United States and must have a United States trustee. Thus, withholding tax should be imposed later, as the IRA proceeds are distributed.¹²⁴

¹²⁰ U.S. Nonresident Alien Income Tax Return.

¹²¹ Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual.

¹²² Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding.

¹²³ Treas. Reg. § 1.1441-1(b)(3)(iii)(C).

¹²⁴ Private Letter Ruling 9206015 (November 7, 1991).

**EXHIBIT F. Sample of Frequently Asked
Questions on Taxation of Distributions from U.S.
and Guam Pension Plans covering Guam and
Mariana Islands Residents**

Background

There are many complex issues facing pension plans and taxpayers based in or doing business in Guam. The following examples of typical problematic scenarios and proposed questions and answers are intended to assist the IRS in creating an educational posting on its website.

Example 1 – U.S. Plans with Participants in Guam

Company X, a U.S. domestic corporation, sponsors a 401(k) profit sharing plan. Bank and Trust, a U.S. Bank serves as Trustee for the 401(k) profit sharing plan. Company X opened an office in Guam and transferred employee Manager to Guam. The 401(k) profit sharing plan allows the employees of Company X based in Guam to participate in the 401(k) profit sharing plan. Manager participates in the 401(k) profit sharing plan. Bank and Trust does not do business in Guam.

Manager retires and moves to Hawaii. After relocating to Hawaii, he takes a lump sum distribution from the 401(k) profit sharing plan and does not roll the distribution over to an IRA or other qualified plan. The distribution is subject to the mandatory 20% withholding under Code § 3405.

Q1. What portion of the distribution is subject to the Guam income tax?

A1. The amount subject to the Guam income tax is the amount of elective deferrals made by Manager while working in Guam and the amount of Company X profit sharing contributions made on behalf of Manager while working in Guam. See Rev. Rul. 2008-40; Rev. Rul. 79-388; Rev. Proc. 2004-37.

Q2. What portion of the distribution is subject to U.S. income taxes?

A2. All of the distribution not subject to Guam income tax will be subject to U.S. income tax. See Rev. Rul. 2008-40; Rev. Rul. 79-388; Rev. Proc. 2004-37.

Q3. Does Bank and Trust pay any portion of the withholding on the distribution to Guam?

A3. Pursuant to Code § 3405(d), the withholding should be paid to the IRS. The plan was qualified with the IRS. The Internal Revenue Code applies. There is no provision to pay the withholding to any agency other than the IRS.

Q4. How does Manager report the income subject to the Guam income tax when he files his U.S. income tax return?

A4. Manager should file IRS Form 5704 with his tax return. This return allocates the 401(k) profit sharing plan distributions between the U.S. and Guam. It is the responsibility of Manager to maintain records to determine the amount of the plan distribution that is subject to Guam income tax and U.S. income tax.

Q5. May Manager directly transfer or roll over the distribution to an IRA (including the portion subject to Guam income tax)?

A5. The amount that would be subject to U.S. income taxes may be rolled over to an IRA. The portion of the distribution subject to Guam income tax may also be rolled over to an IRA. See Code § 402(c) and (d).

Example 2 – Guam Plans

Company Y maintains a plan in Guam. The plan participants reside in Guam. The plan investments include shares of stock in U.S. corporations.

Q1. Is the trust that holds the plan assets a foreign grantor trust?

A1. No. Code §§ 404(a)(4) and 402(c) and (d) treat the trust for the Guam plan as a tax-exempt trust under Code § 501(a). Specifically, Code § 402(c) precludes treatment of the trust as a grantor trust.

Q2. As a foreign trust, are the dividends payable to the trust by the U.S. corporation subject to mandatory withholding under § 1441?

A2. Even though the Guam plan trust is treated as tax exempt under Code § 501(a) for purposes of allowing deductions for contributions, taxation of distributions and allowing rollovers to an IRA or another qualified plan under Code §§ 402 and 404, the trust is a foreign trust for withholding on dividends paid by U.S. corporations to the plan's trust. The trust is not given the status of a tax-exempt trust under § 501(a) but is merely treated as tax exempt for limited purposes.

**ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)**

**RECORD RETENTION REQUIREMENTS FOR
TAX-EXEMPT BONDS AND TAX CREDIT BONDS:
A SPECIFIC PROPOSAL FOR PUBLISHED GUIDANCE**

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June 10, 2009

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EXECUTIVE SUMMARY

This project makes a specific proposal for published guidance addressing the record retention requirements for tax-exempt bonds and tax credit bonds. The project recommends publication of a revenue procedure that establishes safe harbors for certain record retention practices. The report makes a specific recommendation for bonds and tax credit bonds that are issued for the benefit of state and local governments and 501(c)(3) organizations (that is “governmental” bonds that are not private activity bonds under section 141 of the Code, qualified 501(c)(3) bonds issued under section 145 of the Code, and tax credit bonds that have similar qualification requirements, including Build America Bonds issued under section 54AA of the Code). The project contemplates, however, that the same approach should be extended to different types of tax-exempt bonds and tax credit bonds, using the basic framework set forth, but adding additional modules to set forth the specific additional qualification requirements for different types of tax-exempt bonds and tax credit bonds.

The administrative burden of record retention relating to tax-exempt bonds and tax credit bonds is unusually great for a number of reasons. First, many of the qualification requirements for tax-exempt bonds and tax credit bonds apply for the entire term of a bond issue. Because tax-exempt bond and tax credit bond issues commonly have a term of 30 years or more, and are commonly refinanced for even longer terms, an issuer may be required to maintain records to demonstrate tax compliance over a very long period. In addition, a number of detailed and complex qualification rules apply, so that multiple different types of records are necessary to demonstrate compliance.

The special record retention problems in this area have been discussed in prior ACT reports, in public comments in response to Notice 2006-63, and in numerous other less formal stakeholder communications with the Service. Specific approaches to provide record retention guidance and relief have proved to be difficult to develop.

The project recommends that the key to developing practical safe harbor guidance is to link safe harbor record retention relief to the adoption and implementation of reasonable post-issuance tax compliance procedures. Accordingly, the project sets forth both a proposal for specific types of record retention safe harbors and a description of the core elements of post-issuance compliance procedures and practices that are required to qualify for those safe harbors.

The project does not recommend that the published guidance define the substantive standards that may apply to issuers of tax-exempt bonds and tax credit bonds under section 6001 of the Code. Regardless of the technical application of section 6001, it has become increasingly commonplace for issuers of tax-exempt bonds and tax credit bonds to enter into contractual covenants to maintain records

necessary to demonstrate tax compliance. In addition, application of the substantive standards may be different for different types of bonds and records and presents difficult interpretive issues, and likely could require a much longer period to develop. The development of record retention safe harbors can instead be more quickly developed to meet the immediate practical need for guidance.

METHODOLOGY

The team approached this project by first considering the recommendations of prior ACT reports relating to record retention as a whole, reviewing public comments in response to Notice 2006-63, and reviewing the status of the Tax Exempt Bond program in developing responses to those reports and public comments. The team conducted several interviews with officials of TEB to discuss concerns and issues regarding record retention that have arisen in the context of administration of the requirements for tax-exempt bonds, including in examinations, compliance checks, and voluntary closing agreements.

After the development of proposed specific recommendations, the team then sought informal input from a variety of affected stakeholders, including certain members and staff of the Government Finance Officers Association, the National Association of Higher Educational Facilities Authorities, the National Council of Health Facilities Finance Authorities, the National Association of Bond Lawyers, and the Section of Taxation of the American Bar Association. The final project reflects certain input made by these stakeholders.

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DISCUSSION

Prior ACT Reports on the Record Retention Burden for Tax-Exempt Bonds

Prior ACT reports have discussed in some detail the record retention burden faced by issuers of tax-exempt bonds, in particular the 2005 and 2008 ACT reports.

The 2005 ACT Report entitled “Tax Exempt Bonds: Record Retention Burden” emphasized that practical guidance is needed on record retention requirements for tax-exempt bonds, particularly because, in many instances, maintenance of records relevant to tax-exempt bond compliance may be required for periods in excess of 30 years. The 2005 ACT Report made the following specific recommendations:

- The Service should develop a revenue procedure providing guidance on the types of records that issuers of tax-exempt bonds should retain and the related time period for retention of those records.
- The Service should establish a special exception for governmental and qualified 501(c)(3) bond issuers that will ease the burden of recordkeeping for the arbitrage rebate requirements.
- The Service should evaluate the merits of a 2002 proposal on voluntary certification of bond-related records that will allow destruction of certain records prior the general requirements of the Code and regulations.
- The Service should consider establishing a Recordkeeping Agreement Pilot Program similar to the one established by Notice 2004-11 related to the research credit. A similar program could be established for use with complex areas of bond compliance, such as those associated with private use.

The 2008 ACT Report entitled “After the Bonds are Issued: Then What?” emphasized the need for adoption and implementation of post-issuance bond compliance practices and procedures. The 2008 Act Report specifically discussed the importance of record retention as an element of post-issuance compliance practices and procedures.

This report builds on the many of the recommendations of those prior ACT reports.

Actions Taken by the Service relating to Record Retention for Tax-Exempt Bonds

The Service has not published any comprehensive guidance addressing the application of record retention requirements to tax-exempt bonds or tax credit bonds. The applicable regulations do contain scattered record retention

requirements for a number of specific provisions. Most of these record retention provisions refer to the requirement to maintain certain elections or allocations in the books and records of an issue. The most detailed record retention provision for tax-exempt bonds set forth in regulations concerns the safe harbor to establish whether guaranteed investment contracts and investments for yield restriction defeasance escrows are acquired at fair market value. See Treas. Reg. §1.148-5(d)(6)(iii).

In 2003, the Service posted on the webpage for its Tax Exempt Bond program “Tax Exempt FAQs regarding Record Retention Requirements” (the “FAQs”). The FAQs have been modified over time but remain posted on the Tax Exempt Bond webpage. The FAQs note that, during the course of an examination, the Service’s Tax Exempt Bond agents will request all material records and information to support an issue’s compliance with section 103 of the Code. The FAQs set forth a detailed discussion of the records that agents may request, but also indicates that the FAQs are not to be cited as an authoritative source on record retention requirements.

The FAQs state that the requirements of section 6001 of the Code and Treas. Reg. §1.6001-1(a) apply to issuers, conduit borrowers, and bondholders and may apply to other parties to a tax-exempt bond transaction. The FAQs indicate that material records should generally be retained for as long as bonds of an issue are outstanding, plus three years after the final redemption date of the bonds.

Although the FAQs are not formal published guidance, the posting of the FAQs prompted significant reaction among state and local government issuers and bond counsel. In particular, it appears that the posting of the FAQs has resulted in a prevailing practice of including more specific record retention covenants in tax-exempt bond documents.

In Notice 2006-63, the Service requested public comments for developing record retention standards, including recordkeeping limitations programs, for tax-exempt bond issues. The Service in particular asked for public comments on managing any burdens potentially associated with the record retention requirements that apply to issuers and other parties in tax-exempt bond transactions.

In response to Notice 2006-63, the Service received 11 public comments. Most of the comments relate to the special record retention considerations of issuers of bonds for single family and multi-family housing. Public comments addressing the application of record retention requirements to governmental bonds and qualified 501(c)(3) bonds were submitted by the National Association of Bond Lawyers (the “NABL Public Comments”) and the National Association of Higher Educational Facilities Authorities and the National Council of Health Facilities Finance Authorities (the “NAHEFA/NCHFFA Public Comments”).

This report takes into account the public comments made in response to Notice 2006-63.

Tax Compliance Checklists Submitted by the National Association of Bond Lawyers and the Government Finance Officers Association

In light of the Service's increased emphasis of the need for post-issuance compliance relating to tax-exempt bond eligibility requirements, the National Association of Bond Lawyers and the Government Finance Officers Association jointly submitted to the Service and the Treasury form Tax Compliance Checklists (the "NABL/GFOA Checklists"), most recently by a letter dated August 16, 2007. The ACT believes that the NABL/GFOA Checklists represent an important step in the development of industry guidelines for tax-exempt bond compliance, although the NABL/GFOA Checklists do not necessarily correspond in every detailed respect with the recommendations set forth in this report.

The ACT recommends that a guidance project relating to record retention should consider the NABL/GFOA Checklists as a possible model approach for reasonable post-issuance compliance procedures.

IRS Tax-Exempt Bond Compliance Check Questionnaires

In a number of administrative actions since the release of Notice 2006-63, the Service further indicated a view that record retention and other aspects of post-issuance compliance are strongly interrelated.

In 2007, the Service initiated a soft-contact compliance check program to evaluate the post-issuance compliance and record retention practices within the tax-exempt bond industry. In 2007, the Service sent its "Tax-Exempt Bond Financings Compliance Check Questionnaire" (Form 13907) to 207 section 501(c)(3) organizations that are borrowers of tax-exempt bond proceeds. In 2009, the Service sent its "Governmental Bond Financings Compliance Check Questionnaire" (Form 14002) to approximately 200 state and local government issuers of tax-exempt bonds.

Both compliance check questionnaires begin with a Part I that asks questions related to general post-issuance compliance, focusing in particular on whether the issuer or borrower has written procedures to ensure compliance and whether the issuer or borrower has assigned responsibility for identified compliance tasks to specific officials, departments, or functions. The majority of the remainder of each questionnaire asks questions relating to recordkeeping, which include general recordkeeping practices (Part II) and recordkeeping practices relating to investments and arbitrage compliance (Part III), expenditures and assets (Part IV), and private business use.

On September 11, 2008, the Service released its "Interim Report on Charitable Financings: A Summary of Reported Data & Analysis" on its Tax-Exempt Bonds Compliance Check Initiative for charitable financings. This 2008 interim report discusses in detail the responses to the charitable financings compliance check questionnaire and also contains a significant discussion of the Service's views

relating to post-issuance compliance and record retention relating to tax-exempt bonds. Notably, the 2008 interim report emphasizes that the Service “encourages issuers and beneficiaries of tax-exempt bonds to implement procedures that will adequately enable them to safeguard against post-issuance violations that result in loss of the tax-exempt status of their bonds.” The 2008 interim report also specifically references recommendations in the 2005 ACT Report and 2007 ACT Report relating to post-issuance compliance and record retention.

The ACT recommends that a guidance project relating to tax-exempt bond record retention should take into account responses and reactions to these compliance check questionnaires.

New Tax-Exempt Bond Reporting Requirements in Form 990

Substantial new reporting requirements in the redesigned Form 990 even more strongly indicate that the Service has an expectation that 501(c)(3) organization borrowers of tax-exempt bond proceeds will adopt record retention and post-issuance compliance procedures. The new reporting requirements are primarily set forth in the new Form 990 Schedule K. Schedule K requires identification of bond issues benefiting the organization (Part I), detailed information recording how proceeds are spent (Part II), detailed information regarding private business use of bond-financed property (Part III), and certain information regarding arbitrage compliance (Part IV). Perhaps most notably, Schedule K asks whether the organization has “adopted management practices and procedures to ensure the post-issuance compliance of its tax-exempt bond liabilities”. Because Schedule K requires annual reporting, it implies that at least in the case of qualified 501(c)(3) bonds, the borrower has an obligation to monitor tax compliance on an annual basis.

Accordingly, any published guidance project relating to record retention for qualified 501(c)(3) bonds should take into account the new Form 990 reporting requirements and be sufficient for borrowers to meet those requirements. The ACT recommends, however, that the specific wording and approach of Schedule K should be reexamined in the context of such a publication project. For example, it might be appropriate for a revised Schedule K to reference the record retention safe harbors that are set forth in such published guidance.

Recent Increased Importance of Tax Credit Bonds

The American Recovery and Reinvestment Act has greatly increased the importance of tax credit bonds issued under sections 54, 54A and 54AA of the Code. In particular, for any bonds issued after February 17, 2009, through 2010, a state or local government may elect to issue its bonds for governmental purposes either as traditional tax-exempt bonds under section 103 of the Code or as Build America Bonds under section 54AA of the Code. In the case of bonds issued for new capital projects during that period, a state or local government may also elect to issue its bonds as Qualified Build America Bonds, which entitles the issuer to

receive tax subsidy payments equal to 35 percent of interest that is payable on the bonds.

The enactment of the new authorization for Qualified Build America Bonds in particular makes more urgent the need for record retention guidance, because this new type of bond establishes a new administrative relationship of state and local governments to the Service and this relationship raises new and difficult record retention issues. The procedures established for filing for credit payments for Build America Bonds under initial published guidance also imply that the need for record retention guidance is urgent. For example, the initial procedures require an issuer of fixed rate bonds to file a Form 8038-CP with the Service not less than 45 days and not more than 90 days before each interest payment date. This requirement of periodic filing throughout the term of a bond issue further highlights the need for clear safe harbor guidance on record retention and post-issuance compliance procedures, particularly because issuers may have concerns about the level of compliance review that is appropriate to make such periodic filings.

Other types of new tax credit bonds which are authorized to be issued for governmental purposes include Recovery Zone Economic Development Bonds.

The qualification requirements for the new types of tax credit bonds for governmental purposes are in general similar to the requirements for traditional tax-exempt bonds, with certain additional requirements. In particular, Build America Bonds must in general meet all of the eligibility requirements for traditional tax-exempt bonds.

Because of the new importance of tax credit bonds, this report makes recommendations that apply both to traditional tax-exempt bonds and to the new types of tax credit bonds that can be issued for governmental purposes, including in particular Build America Bonds.

Interpretive Issues under Section 6001 and Other Provisions of the Code

Prior ACT reports and public comments in response to Notice 2006-63 generally recommend that the Service publish practical safe harbor guidance on record retention requirements for tax-exempt bonds. This report continues to recommend publication of safe harbor guidance rather than substantive interpretation of how the record retention requirements of the Code apply to tax-exempt bond issuers and borrowers.

The technical interpretation of how record retention requirements may apply in this context likely would require the resolution of a number of difficult interpretive issues that do not need to be definitively resolved to provide helpful guidance. The technical application of record retention requirements may be different for the following types of stakeholders: (1) state and local governments as issuers of tax-exempt bonds; (2) state and local governments as issuers of Qualified Build

America Bonds; (3) conduit borrowers of tax-exempt bonds; and (4) holders of tax-exempt bonds.

In the case of state or local government issuers of tax-exempt bonds, it is uncertain whether the record retention requirements of section 6001 of the Code apply at all, because state and local governments are not liable for income tax. Arguably, the requirement to file the Form 8038 information returns for tax-exempt bonds may result in certain record retention requirements. Even if so, however, the records relevant to those returns only concerns a limited set of the requirements for a bond issue to qualify as tax-exempt. For example, the Form 8038-G concerns only date of issuance information and the Form 8038-T only concerns information relating to “rebate” of certain investment profits when required to be made. In other words, a focus on any record retention requirements derived from information returns is not likely to be helpful in providing an overall framework for bond compliance record retention.

In the case of issuers of Qualified Build America Bonds, a state or local government issuer is placed in an administrative relationship to the Service that is the same as, or very similar to, a taxpayer, because the issuer will receive payments that are treated as tax refunds. A technical interpretation of all of the new record retention implications this new relationship could be difficult.

Conduit borrowers of tax-exempt bonds may be treated as taxpayers subject to income tax relating to tax-exempt bond compliance only in the case of qualified private activity bonds (such as bonds issued for the benefit of 501(c)(3) organizations) that are subject to the “change-of-use penalties” set forth in section 150(b) of the Code. In the case of qualified 501(c)(3) bonds, if an issue is non-compliant with use-of-proceeds restrictions, section 150(b) imputes unrelated business income and denies an interest deduction to the conduit borrower. Because section 150(b) concerns only requirements relating to use of bond-financed property, focus on the possible income tax liability of conduit borrowers is not likely to be helpful in providing an overall framework for bond compliance record retention.

In the case of bondholders (unlike issuers and conduit borrowers), all of the applicable eligibility requirements are material, because in general a bondholder is subject to additional income tax if the bond is noncompliant for any reason. Bondholders, however, rarely have direct control of, or even ready access to, the records necessary to establish compliance.

In addition, a meaningful and complete interpretation of substantive record retention requirements would need to address issues relating to burden of proof, particularly in light of the burden-shifting provisions of section 7491 of the Code. Such guidance would need to address how burden of proof standards may apply differently to different participants in a bond transaction. For example, the burden of proof standards that apply to a bondholder that purchases a bond in good faith

reliance on covenants and representations of an issuer may not necessarily be the same as an issuer that is directly responsible for tax compliance.

The Need for a Practical Safe Harbor Approach

As a practical matter, most issuers are expressly or implicitly contractually obligated to maintain records to establish bond compliance, regardless of the manner in which section 6001 and other record retention provisions of the Code may apply to them. It is commonplace for issuers to broadly covenant in bond documents for the benefit of bondholders not to take any action that would cause the bonds to fail to qualify under the applicable eligibility requirements for tax-exempt bonds or tax credit bonds. In addition, particularly after the posting of the FAQs by the Service in 2003, it has become commonplace for many bond documents to include express record retention covenants. Prompt guidance setting forth reasonable record retention safe harbor guidance is needed to inform issuers on ways to comply with such contractual covenants, even if for no other reason.

The thesis of this report is that the best and most practical approach is to establish flexible record retention safe harbors that are conditioned on the adoption and implementation of reasonable bond compliance procedures. This approach recognizes that record retention is best viewed in the context of overall tax compliance. The ACT believes that this approach can address the administrative goals of the Service to ensure and encourage tax compliance, while at the same time permitting more record retention relief for issuers.

This approach requires both the description of “reasonable bond compliance procedures” and the description of specific record retention safe harbors. The ACT believes that this framework approach could be implemented in a number of different ways. In order to further advance the dialogue with a goal towards moving forward to published guidance, this report sets forth an issues memorandum and draft revenue procedure making a specific proposal for how this framework approach could be implemented.

Description of the Proposed Revenue Procedure

The proposed revenue procedure identifies the core elements of reasonable bond compliance procedures that must be adopted and implemented to qualify for favorable record retention safe harbors. These core elements are identified as (1) reasonable procedures for assignment of compliance responsibilities; (2) reasonable procedures for the establishment and maintenance of books and records; (3) reasonable procedures for compliant investment of gross proceeds; (4) reasonable procedures for the review and allocation of bond proceeds; (5) reasonable procedures for periodic monitoring of use of financed property; and (6) reasonable susceptibility to audit. The proposed revenue procedure acknowledges by specific examples and otherwise that, in light of the great variety of bond issuers and borrowers, a “one size fits all” approach is not workable, and that issuers should have considerable flexibility to meet these core elements.

The proposed revenue procedure then sets forth specific record retention safe harbors for the following types of records: (1) investment requirements; (2) expenditure requirements; and (3) qualified use of bond proceeds and bond-financed property.

A general theme of the record retention safe harbors is that detailed records are required to be maintained only for a minimum period of six years (but not longer than three years after the bonds are retired), provided that summary records are maintained for a general record retention period.

Additional Public Comment

The approach set forth in the proposed guidance project is in certain respects novel and publication of a guidance project using this approach can be expected to have significant impact on the procedures of state and local governments. In that light, although the ACT recommends that the guidance project be set forth in a revenue procedure, the ACT also recommends that the Service and Treasury consider publication of a proposed revenue procedure subject to further public comment.

Recommendations for Regulatory Revisions to Provide Additional Record Retention Relief

The ACT believes that publication of safe harbor guidance on record retention for tax-exempt bonds and tax credit bonds should also be an occasion for the Service and Treasury to consider revisions to regulations to provide additional relief from record retention burden.

Certain provisions of the existing regulations were expressly adopted in order to reduce administrative burden on issuers. The final private activity bond regulations published on January 16, 1997, for the first time set forth an express rule that compliance with the private activity bond requirements for governmental bonds must take into account “deliberate actions” as well as date of issuance reasonable expectations. At the time of promulgation of these regulations, however, neither issuers nor the Service fully understood the large administrative burden imposed by the “deliberate action” rule. The ACT believes that the Service should revisit the scope of exceptions in light of administrative burdens relating to record retention and post-issuance compliance.

In recognition of this administrative burden, Treas. Reg. §1.141-2(d)(5) provides a special rule for general obligation bond programs that finance a large number of different purposes. Under that rule, an issuer can establish compliance with the private activity bond tests based solely on date of issuance reasonable expectations (without taking into account subsequent deliberate actions) provided that a number of conditions are met. The detailed requirements of this special rule, however, make the provision unavailable for many issuers. For example, one condition of the rule is that the issuer must reasonably expect to expend all net proceeds of the bond issue within 6 months of the date of issuance and must

reasonably expect to expend all net proceeds of the bond issuer before expending proceeds of similar general obligation bonds. The preamble to the final regulation adopting this special rule expressly indicates that it was adopted to minimize administrative burden on issuers:

The proposed regulations provide a special exception to the definition of disposition proceeds that is intended to minimize the burden of tracing the use of proceeds of general obligation bonds that finance a large number of projects. Commentators suggested that this exception should be available for other types of bonds and that fewer conditions should apply to the exception.

The final regulations provide a similar rule that is broadly stated as an exception to the rule that a deliberate action after the issue date can cause an issue to fail to meet the private activity bond tests. The exception is intended to provide relief for “cash flow” general obligation bond programs, where issuers use the proceeds of an issue for a large number of projects and spend proceeds promptly. These programs merit special treatment because they further the purposes of the arbitrage rules.

TD 8712, 62 F.R. 2276 (January 16, 1997).

Another example of a regulatory exception that is far too narrowly crafted is the special rule for dispositions of personal property in the ordinary course of business of an established governmental program set forth in Treas. Reg. §1.141-2(d)(4).

Examples of possible revisions to the regulations that could significantly reduce administrative burden include the following: (a) expansion of the special rule for general obligation bonds that finance a large number of separate purposes to make it more widely available to general obligation bond issues that finance capital projects; (b) consideration of other exceptions to the “deliberate action” rule that requires monitoring of use of bond-financed property after the date of issuance, including exceptions for small issuers, (c) expansion of the rule for dispositions of personal property in the ordinary course of an established governmental program so that it applies to qualified 501(c)(3) bonds; and (d) adoption of a regulatory de minimis rule to the requirement for qualified 501(c)(3) bonds that all property must be owned by a 501(c)(3) organization or a state or local government.

A Renewed Call for Simplification

Finally, the ACT recommends that a published guidance project dealing with record retention and post-issuance compliance should be accompanied by a renewed commitment to regulatory simplification to ease the compliance burden on issuers

and borrowers. To a certain extent, the complexity of the tax-exempt bond and tax credit bond requirements is inherent in the detailed provisions of the Code, but the complexity of implementing regulations and published guidance in many cases makes the compliance burden on issuers and borrowers unnecessarily burdensome.

A prime example is the rule for “yield reduction payments” set forth in the arbitrage regulations under section 148 of the Code. These regulations permit an issuer to make payments to the Treasury to reduce investment yield on investments, but only in certain cases which are specified in an unduly complex rule. In cases where yield reduction payments are not permitted, an issuer may be required to achieve compliance by means of complicated investment strategies or a costly voluntary closing agreement. There appears to be no compelling reason why yield reduction payments should not be permitted in all cases.

In 1992, the Service announced a major commitment to simplification of regulatory guidance under section 148 of the Code. See 57 FR 20971. That commitment was followed up with the publication of final regulations in 1993 that took significant steps towards simplification and that identified simplification as a primary objective. Since that time, the Service’s emphasis on tax-exempt bond simplification has largely faded. Now is the occasion for a renewed litmus test for the reexamination and adoption of tax-exempt bond and tax credit bond regulations and other interpretive guidance: are the interpretive rules readily understandable by issuers and readily susceptible to implementation in reasonable post-issuance compliance procedures.

APPENDIX A

TECHNICAL DISCUSSION OF THE APPLICATION OF RECORD RETENTION REQUIREMENTS IN THE CODE TO TAX-EXEMPT BONDS AND TAX CREDIT BONDS

1. RECORDKEEPING REQUIREMENTS UNDER THE CODE AND THE REGULATIONS

General recordkeeping requirements

Although Service officials have publicly stated that tax-exempt bond issuers are under an obligation to maintain tax compliance records, in fact the Code does not directly impose on state and local government issuers any recordkeeping requirement. Section 6001 of the Code provides as follows:

Every person liable for any tax imposed by this title, or the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules or regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title.

Because state and local governments are not “liable” for any income tax, this provision does not apply to them as issuers of tax-exempt bonds. A possible argument could be made that the “rebate” requirement of section 148(f) of the Code is a “tax” for purposes of this provision and that, accordingly, state and local issuers are subject to this requirement with respect to rebate compliance. The Service has, however, in other contexts taken the position that the rebate requirement is framed under the Code as a condition to the tax-exempt status of interest on a bond issue, and is not a “tax.”

As issuers of Qualified Build America Bonds under section 54AA(g), however, state and local governments will receive direct payments from the Treasury that will be treated the same as payments for refundable credits. Accordingly, as an issuer of Qualified Build America Bonds, a state or local government will be in an administrative relationship to the Service that is the same as or very similar to, taxpayers. Thus, there is at least an argument that the requirements of section 6001 of the Code apply directly to issuers of Qualified Build America Bonds, even if they do not apply directly to issuers of tax-exempt bonds.

The recordkeeping requirements of section 6001 of the Code may apply directly to conduit borrowers that are not state and local governments and to bondholders.

Treas. Reg. §1.6001-1(a) provides in general that “any person subject to [income] tax..., or any person required to file an information return with respect to income, shall keep such permanent records ... as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.”

Treas. Reg. §1.6001-1(e) provides that the “books and records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in administration of any internal revenue law.”

Special recordkeeping provisions applicable to exempt organizations

Special recordkeeping requirements apply to exempt organizations:

In addition to such permanent books and records as are required by [Treas. Reg. §1.6001-1(a)] with respect to the tax imposed by section 511 on unrelated business income of certain organizations, every organization exempt from tax under section 501(a) shall keep such permanent books of account or records, including inventories, as are sufficient to show specifically the items of gross income, receipts, and disbursements. Such organizations shall also keep such books and records as are required to substantiate the information required by section 6033 and §1.6033-1 through -3 [relating to returns by exempt organizations].

Treas. Reg. §1.6001-1(c).

Section 6033 of the Code generally requires exempt organizations to file information returns. Section 6033(b) requires a 501(c)(3) organization to file information returns, including “such ... information for purposes of carrying out the internal revenue laws as the Secretary may require.”

The new Form 990 requires a 501(c)(3) organization to report detailed information relating to tax-exempt bonds, including information relating to use of bond-financed property and investments of bond proceeds, particularly in Schedule K.

The Form 990 for prior years contained instructions to line 64a of the Form 990 require an exempt organization to enter “the amount of tax-exempt bonds (or other obligations) issued by the organization on behalf of a state or local governmental unit, or by a state or local governmental unit on behalf of the organization, and for which the organization has a direct or indirect liability” and required information regarding the use of tax-exempt bond-financed property.

Consequences of failure to maintain records

Section 7203 of the Code provides in part as follows:

Any person required under this title to pay any estimated tax or tax, or required by this title or by any regulations made under the authority thereof to make a return, keep any records, or supply any information, who willfully fails to pay such estimated tax, keep such records, or supply such information, at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than \$25,000 (\$100,000 in the case of a corporation), or imprisoned not more than 1 year, or both, together with costs of prosecution.

State and local government issuers are in general required to file Form 8038-G information returns in connection with the issuance of tax-exempt bonds and Form 8038-T in connection with the payment of rebate when required. In general, however, state and local government issuers are not otherwise required to file any other information returns that relate to post-issuance compliance, although issuers of Qualified Build America Bonds are required to file periodic Form 8038-CP returns to receive direct payments from the Treasury.

It appears that there are no reported prosecutions under section 7203 of the Code for the mere failure to maintain records.

Section 6663 of the Code provides that if “any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75% of the portion of the payments which is attributable to fraud.” Some courts have held that a failure to maintain adequate books and records is a strong indication of fraud, particularly if the failure is a part of a consistent pattern. See, e.g., Estate of Upshaw v. Commissioner, 416 F.2d 737 (7th Cir. 1969); Bryan v. Commissioner, 209 F.2d 822, cert. denied, 397 U.S. 962 (1970).

More commonly, failure to maintain records is used by the Service as a factor in asserting accuracy-related penalties. Section 6662 of the Code provides that a penalty equal to 20% of any underpayment may be imposed if the underpayment is, among other things, attributable to “negligence or disregard of rules or regulations.” Section 6662(c) provides that, for this purpose “the term ‘negligence’ includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term ‘disregard’ includes any careless, reckless, or intentional disregard.” See, e.g., Stovall v. Commissioner, 762 F.2d 891 (11th Cir. 1985); Catalano v. Commissioner, 81 T.C. 8 (1983).

None of these provisions should directly apply to state and local government issuers of tax-exempt bonds, because no recordkeeping requirement applies directly to them and they are not liable for income tax. Conceivably, these additional penalties could be applied against an issuer of Build America Bonds or a conduit borrower under section 150(b) that negligently failed to maintain books and records relating to a bond-financed facility. More likely, however, is that certain of the principles developed in case law under the civil fraud and underpayment penalty provisions might be invoked by the Service in determining whether to impose a “penalty” on a tax-exempt bond issuer in establishing the amount of a required settlement payment in closing agreement negotiations.

As a practical matter, the most important recordkeeping questions are (1) whether any particular recordkeeping practices are required to establish that a bondholder is entitled to exclude interest from gross income; (2) whether different standards of recordkeeping apply to different types of bond issues; (3) whether different standards of recordkeeping apply to different bond requirements (for example, to arbitrage and rebate requirements as opposed to use-of-proceeds requirements); and (4) whether recordkeeping failures could subject issuers to harsher treatment in bond examinations. Each of these questions is considered in more detail below.

2. LIMITATIONS PERIODS ON ASSESSMENT

Section 6501(a) of the Code provides in general that “the amount of any tax imposed by this title shall be assessed within 3 years after the date the return was filed.” For this purpose, a return is generally treated as filed on the last day prescribed by law or regulations. In certain cases the statutory period of limitations on assessment may be extended or suspended. Section 6501(e) of the Code provides that if a “taxpayer omits from gross income an amount properly includible therein which is in excess of 25% of the amount of gross income stated in the return, the tax may be assessed ... at any time within 6 years after the return was filed.”

Because of section 6501(e) many tax agreements or tax certificates require issuers or borrowers to maintain records relating to investment of bond proceeds for a 6-year period after the last bond of an issue is retired. The Service’s Tax-Exempt Bond Program has made a number of statements, however, that indicate that the Service expects that issuers and borrowers will maintain such records for a period approximately based on the 3-year limitations period set forth in section 6501(a) of the Code (that is, generally, 3 years after the last bond of an issue is retired). In general, the 3-year period is more appropriate, because including in gross income the interest on a purported tax-exempt bond would be unlikely to cause a typical bondholder to exceed the 25% standard set forth in section 6501(e). In addition, because particular bondholders may have consented to an extension of the limitations period on assessment, even a 6-year records retention period could be insufficient in certain cases.

In any event, many tax agreements and tax certificates appear to contain provisions that only loosely track the limitations period on assessment. The more precise way of describing the period for record retention would be the period ending 3 years after the April 15 following the date on which the last bond of an issue is retired.

3. **BURDENS OF PROOF**

A substantial body of case law in general holds that a taxpayer bears the burden of proving that a claim falls within an exclusion from gross income. See, e.g., Johnson v. United States, 92 AFTR 2d 2003-5969 (10th Cir. 2003); Taggi v. United States, 35 F.3d 93 (2d Cir. 1994). The Supreme Court has broadly stated that “exemptions from taxation are not to be implied; they must be unambiguously proved.” United States v. Wells Fargo Bank, 415 U.S. 351, 354 (1988).

Much of the recent case law concerning burden of proof to establish an exclusion from gross income deals with section 104 of the Code (which excludes from gross income certain compensation for injuries or sickness). In such cases, the information to establish the basis for the exclusion (generally, the nexus between personal injuries or physical sickness and a payment made to a taxpayer) is readily available to, or in the control of, the taxpayer. The applicability of this case law to situations where a taxpayer does not have control of the relevant information (such as a holder of a tax-exempt bond) is uncertain.

Moreover, the analysis of burden of proof is somewhat complicated because Service procedures treat the governmental issuers as tax-exempt bonds as “taxpayers” for many purposes, even though only bondholders or (in the case of section 150(b) penalties) conduit borrowers can be liable for income tax. The Tax Exempt Bond Examination Procedures contained in the Internal Revenue Manual provide that Service agents are to “treat issuers as taxpayers with respect to the bond issue for the following purposes: disclosure; technical advice requests; appeals; and other purposes, as appropriate.” Notably, the TEB Examination Procedures do not provide that issuers are necessarily afforded *all* the procedural rights afforded to taxpayers.

At the inception of the Service’s tax-exempt bond examination program, the Service adopted the approach of treating issuers as taxpayers because of a view that state and local government issuers are entitled to a degree of deference from the Service, because issuers generally have the relevant information to establish the basis for the exclusion from gross income, and because the remedy of taxing bondholders was acknowledged to be burdensome and undesirable. This approach was affirmed, and appears to be mandated, by the IRS Restructuring and Reform Act of 1998. Section 3105 of the IRS Restructuring Reform Act expressly provided governmental issuers with administrative appeal rights:

The Internal Revenue Service shall amend its administrative procedures to provide that if, upon

examination, the Internal Revenue Service proposes to an issuer that interest on previously issued obligations of such issuer is not excludable from gross income under section 103(a) of the Internal Revenue Code of 1986, the issuer of such obligations shall have an administrative appeal of right to a senior officer of the Internal Revenue Service Office of Appeals.

This provision indicates that the Service is required to afford governmental issuers of tax-exempt bonds with procedural protections afforded to taxpayers.

Section 7491 of the Code: statutory shifting of burden of proof

The IRS Restructuring and Reform Act of 1998 also added section 7491 of the Code, which shifts the burden of proof to the Service if certain conditions are met. Section 7491 states that “if, in any court, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B [which includes income tax], the [Service] shall have the burden of proof with respect to such issue.” This shifting of burden to the Service only applies if the following conditions are met:

- (A) the taxpayer has complied with the requirements under [the Internal Revenue Code] to substantiate any item;
- (B) the taxpayer has maintained all records required under [the Internal Revenue Code] and has cooperated with reasonable requests by the [Service] for witnesses, information, documents, meetings, and interviews; and
- (C) in the case of a partnership, corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii) [which concerns eligibility requirements for obtaining reasonable litigation costs from the Service].

Section 7430(c)(4)(A)(ii) of the Code refers to a party “which meets the requirements of the 1st sentence of section 2412(d)(1)(B) of title 28, United States Code (as in effect on October 22, 1986) except to the extent that differing procedures are established by a rule of court and meets the requirements of section 2412(d)(2)(B) of such title 28 (as so in effect).” The referenced section 2412(d)(2)(B) of title 28, United States Code, which also concerns recovery of litigation costs, provides in pertinent part as follows:

any owner of an unincorporated business, or any partnership, corporation, association, unit of local government, or organization, the net worth of which did

not exceed \$7,000,000 at the time the civil action was filed, and which had not more than 500 employees at the time the civil action was filed; except that an organization described in section 501(c)(3) of the Internal Revenue Code ... exempt from taxation under section 501(a) of such Code ... may be a party regardless of the net worth of such organization

The text of section 7491 of the Code indicates that the requirements on net worth and number of employees should not apply to state or local government issuers of tax-exempt bonds that are treated as “taxpayers,” because such an issuer should not be treated as a “partnership, corporation, or trust.” This reading is reinforced by a comparison to the cross-referenced statute, which expressly refers to a “unit of local government,” in addition to a “partnership” or a “corporation.” In addition, significant case law holds that state and local governments are not regarded as “corporations” for certain other purposes of the Code. Under this reading, any state or local government issuer (regardless of size) should in general have the right to shift the burden of proof to the Service, provided in general that the issuer “introduces credible evidence,” “has maintained all records required” under the Code, and “has cooperated with all reasonable requests by the [Service] for witnesses, information, documents, meetings, and interviews.”

There is no authority applying section 7491 of the Code to a tax-exempt bond issuer, and it is not certain that the Service would concur with the foregoing interpretation. The Service might argue that a state or local government should not be treated as a “taxpayer” for this purpose. As is indicated above, the current Tax Exempt Bond Examination Procedures are written in a manner that indicates that the Service does not necessarily accept that tax-exempt bond issuers are afforded all of the procedural rights of ordinary taxpayers. Such a narrow reading of section 7491 would not be well founded, particularly because section 7491 was enacted in the same legislation that affords tax-exempt bond issuers administrative appeal rights as issuers. Moreover, there is no sound policy reason for denying state and local government issuers the procedural benefits of section 7491. In substance, a state or local government issuer in a tax-exempt bond examination not only acts on its own behalf, but is also representing interest of the bondholders. If the examination is not settled at the issuer level, bondholders could have the benefits of section 7491 in litigation. Because many (and often most) of the bondholders of an issue can be expected to be individuals or other entities meeting the eligibility requirements, the Service would need to ultimately respect the application of section 7491.

The application of the requirement that the taxpayer “maintain all records required” under the Code is not clear in this context. Because the Code generally appears to impose no recordkeeping requirements on state and local governments, it could be argued that no recordkeeping is required to shift burden of proof. It is possible, however, that a court might hold that the burden of proof is shifted only if an issuer

maintains records that a bondholder would reasonably need to maintain to establish the exclusion from gross income.

APPENDIX B

ISSUES MEMORANDUM

This Issues Memorandum sets forth issues to be considered and resolved in the development of recommendations for a guidance project concerning record retention requirements for tax-exempt bonds and tax credit bonds. The issues listed take into account public comments made pursuant to Notice 2006-63.

In Notice 2006-63, the Service requested “comments for developing record retention standards, including recordkeeping limitation programs, for tax-exempt bond issues.” The Service invited comments “regarding all aspects of compliance with recordkeeping requirements for tax-exempt bond transactions, including whether different programs may be appropriate for specific types of bond records or specific classes of tax-exempt bond issues.”

In Notice 2006-63, the Service noted that it has “received inquiries regarding the scope and nature of records that issuers and other parties to tax-exempt bond transactions must retain.” The Service further notes that “industry representatives have recommended that the Service issue guidance that would permit a combination of assumptions, certifications, and summaries of original documents to ease the compliance burden.”

The ACT submitted a report on June 8, 2005 on “Tax Exempt Bonds: Record Retention Burden.”

The American Recovery and Reinvestment Act of 2009 and other recent legislation has greatly increased the authorization for tax credit bonds, which generally have a framework of qualifications that is similar to tax-exempt bonds. In this memorandum, references to “bonds” generally refer both to tax-exempt bonds and tax credit bonds.

In this memorandum, references to “issuer” are generally intended to refer to either the governmental issuer or the conduit borrower of a bond issue, as context may require.

Scope of Guidance Project

1. *Should a single guidance project address record retention requirements for all types of bonds, or should several different guidance projects address different types of bonds?*

Discussion: Sections 103, 141 through 150, 54A, 54AA, and other sections of the Code set forth different eligibility requirements for a large number of different types of bonds. In general, however, all of these different types of bonds have the same general framework of imposing restrictions on the use of bond proceeds, the use of financed property and the investment of bond proceeds. In

general, at least certain of these requirements apply to each type of bond after the date of issuance.

On the other hand, different types of bonds generally have different requirements relating to the types of permitted uses of bond proceeds and bond-financed property. For example, the use of proceeds requirements for a governmental bond issue are entirely different than the use of proceeds requirements for an exempt facility bond issue.

Recommendation: The guidance project should set forth a general framework of provisions for record retention standards expenditures of bond proceeds and investment of bond proceeds that could be applied to all types of bond issues, but should initially apply only to certain types of bond issues with similar requirements. The guidance should contemplate that separate “modules” will address record retention requirements relating to the use of proceeds and financed property, and other special requirements, for different types of bond issues.

2. What are the different types of bond issues that may require separate special guidance projects?

Discussion: The Code provides for the following general types of bond issues:

- a. Governmental bonds (sections 103 and 141);
- b. Tribal government bonds (section 7871);
- c. Exempt facility bonds (section 142);
- d. Qualified mortgage bonds and qualified veterans’ mortgage bonds (section 143);
- e. Qualified student loan bonds (section 144(b));
- f. Qualified 501(c)(3) bonds (section 145);
- g. Qualified enterprise zone facility bonds (section 1394).
- h. Build America Bonds (section 54AA).

The Code also provides for certain other types of special tax-exempt bonds and tax credit bonds.

The Code lists 15 different types of “exempt facility” bonds, each with somewhat different requirements relating to use of proceeds for particular capital projects.

All qualified private activity bonds (that is, all bonds other than governmental bonds) are subject to the special requirements of section 147 of the Code, which include a limitations on bond maturity based economic life of financed property (section 147(b)), on use for land acquisition (section 147(c)), on use for acquisition of existing property (section 147(d)), on use for certain prohibited purposes, such as skyboxes (section 147(e)), on use for costs of issuance (section 147(g)) and requiring public approval by a state or local government (section 147(f)). In addition, certain other requirements apply generally to qualified private activity bonds, such as the prohibition on advance refundings (section 149(d)) and change of use “penalties” (section 150(b)). Because these requirements apply to all qualified private activity bonds, there would be some basis to provide guidance relating generally to qualified private activity bonds. On the other hand, the requirements relating to the required use of bond proceeds is quite different among the different types of qualified private activity bonds.

Recommendation: Separate “modules” of guidance should be required for at least the following categories of bond issues: (a) governmental bonds, tax credit bonds with requirements similar to governmental bonds and qualified 501(c)(3) bonds; (b) exempt facility bonds (other than residential rental housing); (c) residential rental housing exempt facility bonds; (d) qualified mortgage bonds and qualified veterans’ bonds; (e) qualified small issue bonds; and (f) qualified student loan bonds.

For this purposes, “governmental” bonds should include the types of tax credit bonds that have use of proceeds requirements that are substantially similar to governmental bonds, including Build America Bonds and Recovery Zone Economic Development Bonds. More generally, references to “governmental bonds” elsewhere in this memorandum are meant to include those types of tax credit bonds, as well as traditional governmental tax-exempt bonds.

An alternative approach would be to include within “governmental” bonds tribal government bonds issued under section 7871 and the additional types of new tax credit bonds authorized under the American Recovery and Reinvestment Act of 2009 (that is, Qualified School Construction Bonds, Qualified Zone Academy Bonds, new Clean Renewable Energy Bonds (to the extent issued by a governmental body under section 54C(d)(3) of the Code), and Qualified Energy Conservation Bonds. Tribal government bonds and each of these new types of tax credit bonds have certain different eligibility requirements, but the same framework for governmental bonds would be applicable.

Each of these modules should build upon the same basic framework for record retention requirements for expenditures and investments, but will need to address the special separate use-of-proceeds requirements and other special requirements.

3. What type of bond issue or bond issues should be the focus of the first guidance project?

Discussion: Governmental bonds are the largest type of tax-exempt bonds by number and volume, and the tax requirements for governmental bonds are generally simpler than for other types of bonds. On the other hand, most of the public comments were received from housing bond issuers, which may reflect the unusually burdensome record retention requirements that apply in particular to single family housing bonds. Unusually burdensome record retention requirements also apply to other types of bonds issues, such as qualified student loan bonds.

Recommendation: The guidance project should first focus on governmental bonds, tax credit bonds with requirements similar to governmental bonds and 501(c)(3) bonds, but acknowledge that the record retention burdens for other types of bonds may be more significant.

4. Should the guidance project interpret the substantive standards for record retention, or rather only set forth a safe harbor?

Discussion: Public comments generally request safe harbor guidance, particularly in light of different record retention practices of many different types of issuers and borrowers. (See, for example, the NABL Public Comments at p. 8). On the other hand, it appears that no published guidance has been issued by the Service setting forth record retention safe harbors.

Recommendation: The guidance project should set forth practical safe harbors, rather than focus on substantive interpretation of record retention requirements.

5. If a safe harbor approach is adopted, should the safe harbor be conclusive or only a rebuttable presumption?

Discussion: Possible approaches are that compliance with safe harbors could permit issuers to establish material facts and other matters in a manner that (1) is conclusive; (2) creates a rebuttable presumption; or (3) shifts the burden of proof to the Service. Safe harbors having conclusive effect may be particularly important in light of the “unqualified opinion” standard that applies to most publicly traded tax-exempt bond and tax credit bond issues.

Most of the safe harbor guidance published in the tax-exempt bond area that has had conclusive effect. For example, the safe harbors for determining whether service contracts result in private business use under Rev. Proc. 97-13 have conclusive effect. Also, the safe harbors for establishing fair market value of guaranteed investment contracts and yield restricted defeasance escrow securities set forth in Treas. Reg. §1.148-5(d)(6)(iii) have conclusive effect.

Recommendation: The presumption should be conclusive for an issuer and bond issue that in good faith meet all of the conditions to qualify for the

safe harbors. The guidance project should state, however, that the Service may determine that the conditions are not met, but only with prospective effect for records retained by the issuer, provided that the issuer has acted in good faith.

6. *Should the guidance project discuss substantive standards for record retention?*

Discussion: As is discussed in the 2009 ACT report, interpretation of promulgation of final rules relating to how section 6001 of the Code applies to tax-exempt bond and tax credit bond issues and issuers may be difficult and time-consuming for a number of reasons. First, it is possible that significantly different rules may apply in different contexts. For example, a different substantive analysis may apply (a) to an issuer of traditional tax-exempt governmental bonds; (2) to an issuer of Qualified Build America Bonds, (c) to a conduit borrower, and (d) to bondholders.

The existing practices of bond counsel and bond issuers relating to contractual covenants expressly requiring record retention vary widely. At a minimum, however, it is likely that such contractual covenants impose record retention requirements on a large portion of issuers. In addition, it is common for issuers to enter into a general covenant requiring the issuer to not jeopardize the tax-exempt status of each bond issue. Under such covenants, bondholders commonly may have the implied contractual right to require reasonable record retention.

Recommendation: The guidance project should not discuss the status of the law relating to application of record retention requirements, but rather provide practical safe harbor guidance.

7. *Should the guidance project make substantive revisions to the regulations to ease recordkeeping burden?*

Discussion: As is set forth in the ACT report, certain provisions of the existing regulations were expressly adopted in order to reduce administrative burden on issuers. For example, Treas. Reg. §1.141-2(d)(5) provides a special burden reduction rule for general obligation bond programs.

Recommendation: As a part of a guidance project on record retention, the Service should also consider revision of certain provisions of the applicable regulations to provide relief from record retention burden. Most importantly, the Service should consider further exceptions to the “deliberate action” rule that requires issuers to monitor use of bond proceeds throughout the term of a bond issue.

8. Should favorable record retention safe harbors apply to small issuers of governmental bonds?

Discussion: Adoption and implementation of formal bond compliance procedures could be unduly costly and burdensome in particular for small issuers of governmental bonds that may not issue bonds frequently and may not have substantial dedicated finance and legal staffs. The ACT received a number of informal comments from stakeholders emphasizing this concern. Certain “small issuer” exemptions from the substantive requirements may be viewed as a Congressional acknowledgement that it is appropriate to provide administrative relief to small issuers of governmental bonds or qualified 501(c)(3) bonds. For example, section 148(f)(4)(D) of the Code generally provides for an exception from rebate for governmental issuers with general taxing powers that do not issue more than \$5 million face amount of tax-exempt bonds in a calendar year. Section 265(b)(3) of the Code generally sets forth favorable treatment for governmental tax-exempt bonds and qualified 501(c)(3) bonds based on a limit of \$30 million face amount of bonds per calendar year.

On the other hand, in general, all the same tax-exempt bond requirements (except for the rebate requirement) apply to issues meeting the small issue exception.

Recommendation: Assuming that the project is framed as a favorable safe harbor, there should be no need for relief from its requirements, but the project should indicate that small issuers have particular flexibility in meeting the eligibility requirements for the safe harbor. In other words, in determining whether the post-issuance compliance procedures adopted and implemented are “reasonable,” the Service should take into account whether an issuer is a small or infrequent issuer.

In addition, the Service should consider revising Treas. Reg. §1.141-2 to make an exceptions for small issuers from the rule that requires deliberate actions changing the use of bond-financed property to be taken into account.

General record retention period

9. What general record retention period should apply?

Discussion: In the “FAQs regarding Record Retention Requirements” posted in the Service’s website, the Service states that “material records generally should be kept for as long as the bonds are outstanding, plus three years.” In its 2008 and 2009 compliance check questionnaires sent to governmental issuers and section, the Service asked whether borrowers retain records for the “life of bonds plus three years.”

This referenced record retention period approximately, but not exactly, corresponds to the expiration of the statute of limitations on the returns of bondholders. Under Treas. Reg. §1.6001-1(e), the Service takes the position that records supporting items in a tax return generally should be retained until the

expiration of the statute of limitations for that return. In most cases, the statute of limitations for an income tax return expires three years after the return is due to be filed. Accordingly, under this approach, material records would generally be required to be kept until three years after the April 15 of the calendar year immediately following the year in which the last bond of an issue is retired. Under this approach, the required record retention period could be more than four years after bonds are retired, rather than three years. The position stated by the Service may reflect a reasonable compromise in light of the considerable administrative burden imposed by tax-exempt bond record retention.

Recommendation: The safe harbor should set forth a record retention period of the term of the bonds plus three years, even though that period does not exactly correspond to the limitations period on assessment.

10. What general record retention period should apply in the case of refunding bonds?

Discussion: In general, a refunding bond issue is treated as financing the same property that was financed by the refunded bond issue. See, for example, Treas. Reg. §1.148-13(b). Accordingly, records relating to expenditures of bond proceeds are generally as relevant to the refunding bond issue as to the refunded bond issue.

The substantive rules relating to use of financed property are more complex, and may differ depending upon the type of bond issue. Under the private activity bond rules that apply to governmental bonds and qualified 501(c)(3) bonds, use of bond-financed property during the period the refunded bond issue was outstanding needs to be considered in determining how the restrictions on use of bond-financed property apply to the refunding bond issue, but in most cases without significant private use the refunding issue is permitted to comply by not taking into account use of financed property during the period the refunded issue was outstanding. Specifically, the regulations dealing with refunding issues under Treas. Reg. §1.141-13 generally provide that a refunding bond issue can be tested separately under the private use restrictions, but that in certain cases an issuer is required to apply the restrictions by treating the refunding bond issue and the refunded bond issue as a “combined issue.” Accordingly, for governmental bonds and qualified 501(c)(3) bonds, records relating to use of bond-financed property during the period the refunded bond was outstanding are relevant for purposes of determining whether the “combined issue” rule needs to be applied and, if so, how it applies.

In general, compliance of a refunding bond issue with the arbitrage yield restriction and rebate requirements of section 148 of the Code does not depend upon whether the refunded bond issue qualified with the requirements of section 148 of the Code. On the other hand, the treatment of proceeds or gross proceeds that transfer from the refunded bond issue to the refunding bond issue under the yield restriction and rebate rules may depend on how those investments

were treated for purposes of the refunded bond issue. For example, the price at which an investment was purchased using gross proceeds of the refunded bond issue may in certain cases be relevant to the price at which the investment is treated as acquired by the refunding bond issue when it transfers to the refunding bond issue.

The FAQs posted on the Service's website acknowledge that some, but not all, refunded bond records continue to be relevant to refunding bonds, but the FAQs do not provide any specific guidance:

For certain tax exempt bond purposes, a refunding bond issue is treated as replacing the original new money issue. To this end, tax-exempt status of a refunding issue is dependent on the tax-exempt status of the refunding bonds. Thus, certain material records should be maintained until 3 years after the final redemption of both bond issues.

Recommendation: The guidance project should provide more guidance on the maintenance of records relating to refunded bonds than is set forth in the FAQs. Specifically, the guidance project should expressly state that (a) records relating to original expenditure of bond proceeds generally need to be maintained for the record retention period of any refunding bonds; (b) records relating to investment of proceeds made during the period a refunded bond was outstanding need to be maintained only to the extent that they concern investments that transfer to the refunding bonds; and (c) records relating to use of bond-financed property generally need to be maintained for the periods relevant under the regulations dealing with how the private activity bond restrictions apply to refunding bonds.

Conditions for qualification for record retention safe harbors

11. *Should the guidance project set forth certain conditions for qualification for favorable record retention safe harbors, or merely set forth safe harbors?*

Discussion: Public comments under Notice 2006-63 generally recommend that the Service adopt safe harbors. A safe harbor approach is likely consistent with the goal to develop practical guidance in a timely fashion.

Public comments generally do not consider whether eligibility for safe harbors should be conditioned on adoption and implementation of reasonable post-issuance compliance procedures.

In some respects, the approach of setting forth safe harbors without specific conditions may be simpler, because it would not require the description and definition of the eligibility requirements (that is, description and definition of "reasonable compliance procedures"). In addition, based on discussions with

certain stakeholders, many issuers have a strong view that safe harbors should not be subject to compliance eligibility conditions.

On the other hand, the tax administration concerns of TEB may make significant record retention relief unacceptable without compensating assurances of tax compliance.

Recommendation: The guidance project should set forth the condition of adoption and implementation of reasonable compliance procedures to qualify for record retention safe harbors. This should enable the adoption of record retention safe harbors that provide substantially more relief of administrative burden.

12. If the adoption of reasonable bond compliance procedures would be a condition to qualification for safe harbor treatment, how should such procedures be described?

Discussion: Public comments emphasize that a “one size fits all” approach is difficult in light of the very large number of different types of bond issues and organizational structures and practices of issuers. In addition, different types of issuers have dramatically different staffs and resources to devote to tax compliance.

On the other hand, it is possible to identify certain core elements of reasonable bond compliance procedures, as are discussed further below.

Recommendation: The project should identify, explain and describe the core elements of reasonable compliance procedures. As is further discussed below, these core elements should be: (a) reasonable procedures for assignment of compliance responsibilities; (b) reasonable procedures for the establishment and maintenance of books and records; (c) reasonable procedures for compliant investment of gross proceeds; (d) reasonable procedures for the review and allocation of bond proceeds; (e) reasonable procedures for periodic monitoring of use of financed property; and (f) reasonable susceptibility to audit.

13. Should the adoption of overall “reasonable bond compliance procedures” be a condition for any of the safe harbors, or should the adoption of only certain types of procedures be sufficient for eligibility for certain safe harbors?

Discussion: One approach to the guidance project is to provide different safe harbor eligibility requirements for different types of records. For example, an issuer could be eligible for a record retention safe harbor by adopting and implementing reasonable bond compliance procedures relating to rebate and yield restriction compliance, but not necessarily qualify for a record retention safe harbor relating to qualified use of bond proceeds and bond-financed property. A different approach is to provide that an issuer is eligible for record retention safe harbors only if it adopts overall reasonable bond compliance procedures. One

argument for the approach requiring complete compliance procedures is that the various eligibility requirements (for example, investment, expenditure and use of proceeds) are often interrelated.

Recommendation: The guidance project should provide that an issuer generally will be eligible to qualify for record retention safe harbors only if it adopts overall reasonable bond compliance procedures, but the guidance project should also acknowledge that exceptions to this approach may be appropriate.

14. Should the identification of responsible officers, departments or other functions of an issuer for different compliance tasks be a required element of reasonable bond compliance procedures?

Discussion: Bond agreements and documents commonly describe compliance requirements, but do not commonly assign responsibility for different tasks within the issuer's or borrower's organization. Failure to clearly identify responsibility for different compliance tasks may be the cause of a significant portion of the noncompliance that exists. The 2008 ACT Report emphasized the need for issuers to assign compliance task responsibilities.

Recommendation: A procedure identifying or assigning the responsibility for core tax-exempt bond compliance tasks should be a required element of reasonable bond compliance procedures. The guidance project should emphasize, however, that different organizational structures and other circumstances of issuers may permit or require a wide variety of how such responsibilities are assigned. The guidance project should expressly acknowledge that a procedure identifying a single official or department as responsible for all tax-exempt bond compliance tasks may be reasonable, depending on the facts and circumstances.

To be most helpful, the guidance project should set forth examples of different reasonable ways for assigning compliance tasks based on the particular facts and circumstances of different issuers.

15. Should the establishment of books and records files for each bond issue be a required element of reasonable bond compliance procedures?

Discussion: The tax-exempt bond regulations refer in a number of different provisions to the "books and records" of a tax-exempt bond issue, but do not attempt to define or describe the appropriate contents of such "books and records". Many issuers appear to mistakenly believe that the "books and records" consist only of the bond transcript, but the regulations plainly contemplate that many documents not customarily contained in the bond transcript are also part of the "books and records". Commonly, the different types of books and records may be maintained by different officials, departments, or functions within an issuer. Requiring the identification of different types of books and records files should

provide a mechanism to clarify the record retention responsibility for different types of records. One example of the types of files that should be established for the “books and records” of a bond issue is the following:

- a. The bond transcript.
- b. Requisitions to the bond trustee.
- c. Other information showing how the bond proceeds are spent, which may include invoices and checks or other verifiable information.
- d. Records showing actual payments of debt service on the issue.
- e. The bond proceeds expenditure certificate and other post-issuance tax allocations and elections, if any.
- f. Records of all investments of bond proceeds and any other “gross proceeds” of the bonds.
- g. Records establishing the use of all property financed with proceeds of the bond issue, including service contracts and leases.
- h. Records, certifications, and opinions relating to any “change of use” of bond-financed property, including remedial action certificates and opinions.
- i. Records relating to extensions or replacements of guarantees of bonds of the issue, such as letters of credit, and records showing the dates and amounts of any payments for guarantees.
- j. Records relating to interest rate swaps or other derivatives relating to the bonds entered into after the date of issuance, if any, and records showing the dates and amounts of any payments and receipts with respect to each derivative contract.
- k. Records relating to any modifications of the bonds or the bond documents of the bond issue, including amendments to bond documents and interest rate mode conversions.

Recommendation: A procedure for identifying books and records files for each bond issue and for identifying the officials, departments or functions responsible for maintaining each books and records file should be a required element of reasonable bond compliance procedures. The published guidance should contemplate that issuers have flexibility in how books and records files are identified, provided that they are identified in a manner that is consistent with assignment of responsibility for record retention of different files.

16. Should a procedure for review and allocation of expenditures of bond proceeds be a required element of reasonable bond compliance procedures?

Discussion: The tax-exempt bond regulations generally contemplate that an issuer will make a final allocation of how bond proceeds are spent, which may not be exactly the same as how bond proceeds are originally drawn down for expenditures. The most relevant provisions of the regulations are set forth in the so-called “allocation and accounting rules” in Treas. Reg. §1.141-6(a):

(a) **Allocation of proceeds to expenditures.** For purposes of 1.141-1 through 1.141-15 [the private activity bond regulations], the provisions of 1.148-6(d) apply for purposes of allocating proceeds to expenditures. Thus, allocations generally may be made using any reasonable, consistently applied accounting method, and allocations under sections 141 [relating to private use] and 148 [relating to arbitrage] must be consistent with each other.

The Service has published more extensive proposed “allocation and accounting rules” which are not currently effective, but which are discussed in detail below.

For purposes of this discussion, the most relevant portions of the cross-referenced arbitrage “allocation and accounting” regulations are set forth in Treas. Reg. §1.148-6(d)(1):

(i) **General rule.** Reasonable accounting methods for allocating funds from different sources to expenditures for the same governmental purpose include any of the following methods if consistently applied: a specific tracing method; a gross proceeds spent first method; a first-in, first-out method; or a ratable allocation method.

(ii) **General limitation.** An allocation of gross proceeds of an issue to an expenditure must involve a current outlay of cash for a governmental purpose of the issue. A current outlay of cash means an outlay reasonably expected to occur not later than 5 banking days after the date as of which the allocation of gross proceeds to the expenditure is made.

(iii) **Timing.** An issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the

issue is placed in service. This allocation must be made in any event by the date 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier. This paragraph (d)(1)(iii) applies to bonds issued on or after May 16, 1997.

The general provisions of the arbitrage allocation and accounting rules provide the framework for these rules for allocating bond proceeds to expenditures:

(1) Reasonable accounting methods required.

An issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue.

(2) Bona fide deviations from accounting method.

An accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item. Bona fide governmental purposes may include special State law restrictions imposed on specific funds or actions to avoid grant forfeitures.

(3) Absence of allocation and accounting methods.

If an issuer fails to maintain books and records sufficient to establish the accounting method for an issue and the allocation of the proceeds to an issue, the rules of this section are applied using a specific tracing method. This paragraph (a)(3) applies to bonds issued on or after May 16, 1997.

Taken together, these regulations plainly contemplate that an issuer must make a final allocation of how bond proceeds are spent within a reasonable period (generally 18 months) after a financed project is placed in service. These regulations do not, however, require any special review of how bond proceeds are spent, but rather provide a “specific tracing” default rule if no action is taken.

Recommendation: A procedure for review of expenditures of bond proceeds within the time period permitted in the above-referenced regulations should be a required element of reasonable bond compliance procedures.

17. Should periodic monitoring of use of bond-financed property be a required element of reasonable bond compliance procedures?

Discussion: In general, the requirements relating to use of bond-financed property are interpreted by the Service to apply throughout the term of a

bond issue. In the case of governmental bonds and qualified 501(c)(3) bonds, the applicable regulations generally require that any “deliberate action” with respect to use of financed property must be taken into account. See Treas. Reg. §1.141-2(d). This “deliberate action” rule implies an obligation to monitor use of bond-financed property throughout the term of a bond issue, and is the source of much of the compliance and record retention burden imposed on issuers. For governmental bonds and qualified 501(c)(3) bonds, the qualified use restrictions generally do not apply on an annual basis, but rather are based on use during the “measurement period” for bond-financed property, which generally begins on the later of the date of issuance or the date the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity of any bond of the issue. The average percent of nonqualified use, however, is determined by using the average percentages of nonqualified use during one-year periods. In other words, the applicable regulations imply some degree of annual monitoring of nonqualified use but also permit compliance to be measured over periods much longer than one-year.

For qualified 501(c)(3) bonds, the new Form 990 Schedule K will require annual reporting of the amount of private business use for each bond issue that is issued after 2002. This reporting requirement does not apply to governmental bonds.

Recommendation: Periodic monitoring of use of bond-financed property should be a required element of reasonable bond compliance procedures. For qualified 501(c)(3) bonds subject to the detailed Form 990 Schedule K reporting requirements, the monitoring period should be annual. For governmental bonds and qualified 501(c)(3) bonds not subject to the detailed Form 990 Schedule K reporting requirements, the monitoring period should be a longer interval, perhaps 5 years.

18. Should susceptibility to reasonable audit procedures be a required element of reasonable bond compliance procedures?

Discussion: Because the tax certificates and tax agreements included in bond documents customarily do not assign responsibility for specific compliance tasks to specific employees, departments, or functions, it may be very difficult for an internal or external auditor to verify that an issuer is complying with its bond compliance responsibilities.

Recommendation: The guidance project should make susceptibility to reasonable audit procedures a required element of reasonable bond compliance procedures. The guidance project should indicate that susceptibility to either internal or external audit meets this requirement. The guidance project should not require, however, that an issuer’s bond compliance procedures be actually subjected to audit.

19. Should the establishment of a “deadline reminder system” or “tickler file” be a required element of reasonable bond compliance procedures?

Discussion: In many cases, the tax compliance deadlines set forth in bond documents (such as the date rebate payments are due or the date amendment of private use contracts is required) are “buried” in the text of tax certificates, and are not separately set forth in any form of deadline reminder system. A substantial portion of noncompliance may be based on simple oversight, because deadlines are not made more readily visible to responsible officials.

Recommendation: The establishment of a deadline reminder system or “tickler” file should not be identified as a separate core element of reasonable bond compliance procedures, but should be described as a strong factor tending to establish that an issuer has implemented reasonable bond compliance procedures.

20. Should evidence of actual implementation of bond compliance procedures be a condition for qualification for record retention safe harbors? If so, how should the required implementation be framed in the guidance project?

Discussion: Mere adoption of written bond compliance procedures, without good faith implementation, provides little or no additional assurance of tax compliance. Defining a requirement of good faith implementation, however, may be more difficult than defining the core elements of reasonable bond compliance procedures.

Recommendation: Good faith implementation of bond compliance procedures should be a condition for eligibility for the record retention safe harbors.

21. If the adoption and implementation of reasonable bond compliance procedures is a required condition for record retention safe harbors, should issuers be required to consistently implement the procedures for all types, or only specified types of, its bond issues to qualify?

Discussion: Different bond compliance procedures in many cases will be required for types of bonds that are subject to different substantive requirements under the Code (for example, governmental bonds as compared to qualified 501(c)(3) bonds). One goal of the guidance project should be to make safe harbors available to issuers as promptly as possible and to encourage issuers to implement and continue to implement bond compliance procedures. Imposing a requirement that record retention safe harbors are available only to an issuer that has adopted and implemented reasonable bond compliance procedures for all types of bonds could substantially delay and lessen the usefulness of the safe harbors.

In addition, particularly in the case of many governmental bond issues, different employees, departments or functions may be responsible for bond

issuance and compliance. For example, the departments of a city responsible for issuance of general obligation bonds may not be the same as the departments responsible for issuance of water revenue bonds.

Recommendation: An issuer should be eligible for the safe harbors if it adopts reasonable bond compliance procedures for any category of its bonds. In general, categories of bonds should be defined as types of bond issues that are subject to different requirements under the Code. In the case of governmental bonds, however, a category of bonds should also be more liberally defined as types of bond issues that are issued under different state law authority.

22. Should any other required elements of reasonable bond compliance procedures be set forth?

Discussion: Certain types of bond issues may have special compliance requirements that might not be readily identified as coming within the scope of the six core elements described above. For example, in the case of certain long-term working capital deficit financings, issuers have covenanted to apply any available amounts to redeem bonds on a periodic basis.

Recommendation: The guidance project should contemplate that additional elements may be appropriate in special cases.

Standards for records of expenditures of bond proceeds

23. Should issuers be required to retain records of checks and invoices, or is retention of summary ledger statements sufficient?

Discussion: The NABL Public Comments (p. 9) make the following recommendation:

NABL recommends that issuers of bonds (or in the case of conduit borrowings, conduit borrowers) be permitted after a reasonable period (e.g., seven years) to summarize the expenditure of bond proceeds, and then be able to destroy the underlying original purchase invoices, cancelled checks, bank statements, and similar records relating to the expenditures. [footnote omitted] The expenditure summary should contain sufficient information to establish compliance with Code restrictions, such as the date, amount, and purpose of the expenditures. ...Disposal of the underlying records would not be permitted, however, at any time when an examination of the bond issue or any refunding bond issue is open.

The 2005 ACT Report (p.9) makes the following recommendation:

...instead of requiring that all invoices be retained, establish rules [to the effect that] only invoices over a designated amount (e.g., \$1 million) must be retained. Alternatively, the Service might consider requiring that invoices greater than a specified percentage of bond proceeds be retained.

The Service could require that only invoices supporting the expenditure of a certain dollar amount or a specified percentage of the bond issue must be maintained as long as summary information (general ledger detail) exists for all expenditures related to the bond issue. For example, the Service might consider a requirement that only invoices representing expenditure to a single contractor that exceeds $\frac{1}{4}$ of one percent of the net proceeds of the bond issue must be retained for the life of the bonds.

Recommendation: Records of checks and invoices should be required to be maintained only for a limited period. Even for that period, a reasonable de minimis rule should apply to the general requirement to maintain records of checks and invoices. The acceptability of any such de minimis rule should be considered in light of the tax compliance assurances provided by reasonable bond compliance procedures that require a final review of expenditures and maintenance of summary expenditure statements. In that light, a liberal de minimis rule should apply for retention of checks and invoices, perhaps 5 percent of net proceeds of the bond issue.

Retention of summary expenditure statements should be sufficient, subject to specified minimum standards.

24. *If retention of summary expenditure statements is sufficient, what are the minimum requirements for such summary expenditure statements?*

Discussion: The NABL comments recommend that an expenditure summary should “contain sufficient information to establish compliance with Code restrictions, such as date, amount, and purpose of expenditures.” NABL also suggests that inclusion of model summary statements would be helpful.

Any summary statement or statements would generally need to include the date (or date range) and amount of the expenditure. With respect to the date, there can be a difference between the date an expenditure is actually made to an unrelated third party by an issuer, the date on which an issuer requisitions the amount from a bond trustee, and another possible date on which the issuer makes an allocation for tax purposes. Of these, the most important dates are probably the

dates on which the issuer actually made an expenditure to an unrelated third party and the date on which a final allocation of the bond proceeds was made.

The description of “purpose” needs to be sufficiently detailed to establish compliance, and requires further consideration. For governmental bonds and 501(c)(3) bonds, the description of purpose needs to be sufficiently detailed to identify the property that may be subject to private use. The proposed “allocation and accounting rules” under section 141 contemplate that a “project” is the unit of property. See Prop. Treas. Reg. §1.141-6(b)(2). Thus, the summary should probably contain sufficient information to determine whether it is treated as part of any “project”.

Consideration should be given to whether the expenditure summary should be required to indicate the identity of the recipient, or at least to verify that the issuer reviewed the expenditure to determine that the recipient was an “unrelated party” to the issuer and that the recipient is a provider of the goods or services described.

In addition, particularly in the case of qualified private activity bond issues (which are subject to a two percent limitation on use of bond proceeds to finance costs of issuance), the “purpose” needs to be sufficiently detailed to indicate whether the cost is an issuance cost.

Consideration should be given to whether the expenditure summary should be required to indicate the placed-in-service date of the property. The placed-in-service date is relevant to the measurement of private business use. Under the applicable regulations, the “measurement period” of use of property is generally determined over the reasonably expected economic life of the property, commencing with the placed-in-service date. See Treas. Reg. §1.141-3(g)(2). Also, under section 147(b)(3), the determination of economic life is made as of the date bond-financed property is placed in service.

One possible approach is not to require records relating to placed in service date if the issuer makes certain conservative assumptions.

Recommendation: An expenditure summary qualifying for the safe harbor should include the following information: (a) the amount of expenditure for each separate project or purpose; (b) a description of each separate project or purpose; (c) date of the expenditure or reasonable date range during which the expenditure was made; (d) except as provided by this section, the reasonably expected weighted average maturity of each separate project or purpose; and (e) the placed in service date of each separate project or purpose that is a capital expenditure or reasonable placed in service date range.

25. Even if summary expenditure statements are generally permitted, should issuers be required to maintain records of checks and invoices for a minimum period of time?

Discussion: TEB has an interest in ensuring that detailed expenditure records are maintained for at least a minimum period so that at least some examinations of detailed underlying records will be possible.

Recommendation: Issuers should be required to maintain records of checks and invoices for a minimum detailed record retention period of six years.

26. Should more flexible record retention standards for expenditures apply in the case of governmental bonds, as contrasted with qualified private activity bonds?

Discussion: The expenditure records of state and local governments are generally subject to state open public records “sunshine laws” that do not typically apply to conduit borrowers. Also, the expenditure records of state and local governments are often subject to special checks and balances under state law. (See, for example, the NABL Public Comments at p. 6).

In general, the Code and the regulations generally provide for more flexible treatment for governmental bond issues than for qualified private activity bonds. In the case of qualified 501(c)(3) (other than qualified 501(c)(3) bonds) qualification generally affirmatively requires use of proceeds for qualified uses. In the case of governmental bonds and qualified 501(c)(3) bonds, however, the Code in general does not affirmatively require any particular type of use of proceeds, but rather provides that an issue does not qualify if it has more than de minimis nonqualified use.

Recommendation: The guidance project should provide that the same flexible record retention standards apply to governmental bonds and qualified 501(c)(3) bonds. Further consideration should be given to whether more rigorous expenditure record retention standards should apply to other types of qualified private activity bonds.

27. Should record retention standards for expenditures set forth a de minimis rule for small expenditures?

Discussion: Both the 2005 ACT Report and the NABL Public Comments recommend that the Service should adopt de minimis exceptions for expenditure record safe harbors.

The 2005 ACT Report recommends that only invoices over a designated amount (for example, \$1 million) should be required to be maintained or that the Service consider requiring only that invoices over a specified percentage of proceeds (for example, $\frac{1}{4}$ of one percent of net proceeds) should be required to be maintained.

The NABL Public Comments (at p. 10) recommend that issuers be permitted to destroy at any time records for individual expenditures below a certain dollar threshold (for example, one percent of proceeds), provided that a summary expenditure record is retained.

Provisions in the tax-exempt bond regulations that provide for de minimis rules could provide other benchmark standards by analogy. For example, Treas. Reg. §1.148-7(b)(4) provides the following de minimis rule for purposes of meeting spending exceptions to the rebate requirement of section 148(f) of the Code:

Any failure to satisfy the final spending requirement of the 18-month exception or the 2-year exception is disregarded if the issuer exercises due diligence to complete the project financed and the amount of the failure does not exceed the lesser of 3 percent of the issue price or \$250,000.

Section 148(e) of the Code in effect establishes a statutory de minimis exception from the yield restriction requirement in an amount that “does not exceeds the lesser of . . . 5 percent of the proceeds of the issue, or . . . \$100,000.

Treas. Reg. §1.141-3(d)(5) establishes a de minimis rule for private business use purposes that disregarded nonpossessory “incidental use” provided that “all nonpossessory uses of the facility do not, in the aggregate, involve the use of more than 2.5 percent of the facility.”

Recommendation: In general, a de minimis exception should be based on an overall percentage limit of net proceeds and a dollar amount limit per separate project or purpose. Such an approach would be similar to the approach used for the rebate spending exception de minimis exceptions, although the percentage and dollar limits would not be exactly the same.

The safe harbors should provide that an issuer is permitted to certify that a de minimis amount not to exceed 5 percent of the issue price and not to exceed \$250,000 on any single project or purpose is spent on qualified purposes, provided that the issuer makes a good faith certification to that effect. For this purpose, a “project” should be defined by reference to the definition of “project” under the private activity bond allocation and accounting rules under Treas. Reg. §1.141-6. In addition, a purpose should include different working capital purposes.

28. If record retention standards for expenditures set forth a de minimis rule for small expenditures, should the de minimis rule apply to only certain types of expenditures (for example, equipment)?

Discussion: In practice, it is often more difficult for issuers to trace and monitor the use of proceeds for equipment than it is to trace and monitor the use of proceeds for buildings and structures. For that reason, a rule providing de

minimis relief could be limited to certain types of property that are difficult to trace and monitor, such as equipment.

Recommendation: The guidance project should not limit a de minimis exception for expenditures to certain types of property.

29. Should special record retention standards for expenditures apply in cases where the allocation of bond proceeds for federal income tax purposes is different than the allocation for state law purposes?

Discussion: The tax-exempt bond allocation and accounting regulations expressly contemplate that bond proceeds may be treated as spent in a manner different than they are treated as spent for state law purposes. Treas. Reg. §1.148-6(a) generally provides that an issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, expenditures, and investments of an issue and that an accounting method does not fail to be reasonable and consistent solely because a different accounting method is used for a bona fide government purpose to account for a particular item.

Recommendation: No special requirements should apply in cases where the allocation of bond proceeds for federal income tax purposes is different than for state law purposes. The requirement of reasonable procedures for the review and allocation of expenditures should provide sufficient assurance of compliance.

30. Should record retention safe harbor standards apply to equity contributions to projects financed in part with tax-exempt bond proceeds that are similar to the standards for expenditures of bond proceeds?

Discussion: Proposed regulations under the private activity bond requirements of section 141 of the Code provide that an issuer can qualify for favorable treatment under the use-of-proceeds restrictions by funding a portion of a project with cash amounts that are not tax-exempt bond proceeds (“equity”). See Prop. Treas. Reg. §1.141-6, which provides that in certain cases the nonqualified use of a project can be associated with the portion of the project funded with equity. The proposed regulations also contemplate, however, that this favorable treatment is available only if the issuer makes certain allocations and maintains records of the equity contribution.

Recommendation: The guidance project should provide that the same standards that apply to records of expenditures of proceeds also apply to records of expenditures of equity.

Standards for records of investments

31. Should issuers be required to retain detailed records of the purchase, disposition, and receipts of investments?

Discussion: Determination of compliance with the rebate and yield restriction requirements requires maintenance of detailed investment records.

Recommendation: The guidance project should require maintenance of detailed investment records for a minimum record retention period.

32. Should the guidance project indicate that bond trustee statements are sufficient records of investments, except in special cases?

Discussion: The principal investment records retained by many issuers may be bond trustee statements. Commonly, these statements will contain the requisite detailed information to establish compliance with rebate and yield restriction requirements, other than whether investments are acquired or sold at fair market value.

Recommendation: The guidance project should not set forth a special rule for bond trustee records.

33. Should issuers be required to retain only summary investment records, such as rebate reports?

Discussion: The NABL Public Comments (at p. 12), the NAHEFA/NCHFFA Public Comments (at p. 3) and the 2005 ACT Report all recommend that summary reports, such as rebate reports, should be sufficient to establish compliance with investment restrictions, at least after a minimum record retention period. In many cases, however, rebate reports are not prepared.

Recommendation: The retention of rebate reports, or the equivalent of rebate reports, should be sufficient to establish compliance with rebate and yield restriction requirements after a minimum record retention period.

34. If issuers are required to retain only summary investment records, what are the minimum requirements for such investment records?

Discussion: Rebate records generally provide a summary of investment activity. Issuers do not obtain formal rebate reports for all bond issues, however. For example, some bond issues may meet a rebate exception for small issues may manifestly meet a rebate exception or have no investment profit.

In addition, rebate reports are prepared with different levels of detail. For example, some rebate reports use the so-called “investment method”, which provides a complete record of all investment experience. Other rebate reports use the so-called “disbursement method”, which may only provide a record of initial

investment and expenditures. A disbursement method rebate report will show overall results, but not a summary of all actual receipts and disbursements.

Recommendation: A summary rebate report using either the “investment method” or the “disbursement method” (or comparable report) should be sufficient.

35. Should special recordkeeping requirements apply to guaranteed investment contracts and investments for yield restricted defeasance escrows?

Discussion: The arbitrage regulations set forth special record retention requirements for complying with a regulatory safe harbor for establishing the fair market value of guaranteed investment contracts and yield restricted defeasance escrows for the purpose of complying with the arbitrage requirements of section 148 of the Code. See Treas. Reg. §1.148-5(d)(6)(iii)(E). The detail of these required records appears to indicate a concern on the part of the Service that such investments may be an area of potential abuse under the arbitrage requirements.

Recommendation: The special record retention requirements relating to guaranteed investment contracts and yield restricted defeasance escrows should not be superseded by the new guidance project.

Standards for records of use of bond-financed property

36. Should issuers be required to retain copies of all contracts for use of bond-financed property?

Discussion: The record retention FAQs posted on the Service's website state that issuers should maintain “documentation evidencing use of bond-financed property by public and private sources (i.e., copies of management contracts and research agreements).” The determination of whether a contract results in nonqualified use in many cases requires a detailed review of the terms of the contract (for example, under the detailed standards set forth in Rev. Proc. 97-13, as amended).

In practice, a requirement to maintain copies of agreements for very long periods may be particularly burdensome for issuers and is likely in many cases different than customary practice.

Recommendation: Issuers should be required to retain copies of contracts for use of bond-financed property only for a minimum record retention period.

37. Should issuers be permitted to retain only a summary of contracts for use of bond-financed property?

Discussion: Unlike records relating to expenditures and investments, records relating to arrangements for use of bond-financed property are not customarily maintained by issuers as a part of general accounting records. In addition, in the case of some bond issues an issuer may enter into a very large number of contracts and other arrangements for use of the bond-financed property. In part for these reasons, record retention for use of bond-financed property in many cases may be particularly burdensome. In light of this administrative record retention burden, it is particularly important that safe harbors provide record retention relief regarding contracts for use of bond-financed property.

Recommendation: Issuers should be permitted to retain only a qualified use compliance certificate meeting specified standards.

38. Should issuers be permitted to retain only a “compliance certificate” relating to use of bond-financed property.

Discussion: The record retention requirements for arrangements for use of bond-financed property raise unique considerations, because these records in general are more likely to implicate legal determinations than records relating to expenditures and investments, which generally concern matters of fact. That is, a review of whether an arrangement results in nonqualified use often requires a complete review of all terms of the arrangement. Any meaningful record retention relief, however, would require only retention of summary information relating to the arrangement or overall compliance with the restrictions on nonqualified use.

Recommendation: After a detailed record retention period, an issuer should be permitted to retain only a qualified use compliance certificate to conclusively establish qualified use for the period covered, even if that compliance certificate establishes whether the contract results in nonqualified use. A certification effectively establishing matters of law should have adequate safeguards against abuse in light of the requirement of good faith implementation.

39. If issuers are permitted to retain only a “compliance certificate” relating to use of bond-financed expenditures, what should be the required content, and procedures to complete, such a compliance certificate?

Discussion: A number of different approaches for the required content of a qualified use compliance certificate are possible. At one extreme, the guidance project could require a compliance detail to describe in detail the material terms of each contract, including exact dates the contract was effective, a detailed description of compensation arrangements, and a detailed description of bond-financed property use. At the other extreme, the guidance project could require only a summary certificate to the effect that the issue was compliant with use restrictions during the period covered.

Because, in the case of governmental bonds and qualified 501(c)(3) bonds, nonqualified use is generally measured over a measurement period based in part on the reasonably expected economic life of financed property and by taking into account average nonqualified use during annual periods, the percentage of nonqualified use in annual periods is material to ongoing compliance.

Recommendation: The guidance project should adopt a reasonable middle ground approach for the required contents of a qualified use compliance certificate. In general, such a certificate should be required only to list all arrangements for use of the bond-financed property, including an identification of any arrangements that result in private business use and include certifications to the effect that all the listed arrangements have been reviewed to determine whether they result in nonqualified use and stating the total amount of nonqualified use during the period covered. For qualified 501(c)(3) bonds, a properly completed Schedule K should meet the requirement of providing a certification regarding the total amount of nonqualified use.

40. Should record retention standards for expenditures set forth a de minimis rule for use of property financed with only a small amount of expenditures?

Discussion: Record retention burden for use of bond-financed property in general is at least as great as the record retention burden for expenditures, particularly because issuers do not customarily retain records relating to use arrangements as a part of general accounting records.

Recommendation: The guidance project should provide the same de minimis rule for qualified use records that is applied to expenditure records. Accordingly, the safe harbors should provide that an issuer is permitted to certify that bond-financed property financed with proceeds in an amount not to exceed 5 percent of the issue price and not to exceed \$250,000 on any single project or purpose is used on qualified purposes, provided that the issuer makes a good faith certification to that effect

41. Should any special record retention requirements apply to a bond issue if the issuer has taken a “remedial action” to cure noncompliance?

Discussion: “Remedial action” records to cure noncompliance may in certain cases not be consistently maintained because they arise after the date of issuance and are not expected as of the date of issuance.

Recommendation: No special record retention requirements should apply to “remedial action” records, but the guidance project should indicate that remedial action records are generally required to be maintained as part of the books and records for an issue.

Standards for records of special tax elections and other special tax actions

42. *Should special record retention requirements apply to tax elections and other special tax actions?*

Discussion: The Code and regulations contain a number of special tax elections that may be made, and in certain cases are required to be made, for different types of tax-exempt bonds. In addition, the Code and regulations provide for other types of special tax actions, which include “allocations” of bond proceeds and bonds.

The special tax elections set forth in the Code include the following:

- a. Election to treat a bond issue as a portion of a governmental bond and a portion of a qualified 501(c)(3) bond (section 141(b)(9));
- b. For exempt facility bonds for airports, docks and wharves, mass commuting facilities, and environmental enhancements of hydroelectric facilities, the required election of lessees not to claim depreciation or investment tax credit (section 142(b));
- c. For exempt facility bonds for residential rental housing, the election to comply with the “set-aside” requirement for low income tenants based on the “20-50 test” or the “40-60 test”;
- d. For exempt facility bonds for local furnishing of electric energy or gas, the election to terminate tax-exempt bond financing (section 142(f)(4)).
- e. For qualified small issue bonds, the election to use the \$10,000,000 small issue bond limit (section 144(a)(4) of the Code).
- f. For rebate purposes, the election to treat a portion of an issue as a “construction issue” eligible for the two-year rebate exception (section 148(f)(4)(C)(vii).

In addition, a number of special rules apply to the allocation and carry forward of volume cap under section 146 of the Code.

For the most part, the tax elections required to be made by the Code must be made on or before the date of issuance and are customarily made in the tax document or other document or agreement (such as a lease agreement) that is entered into on or before the date of issuance. Accordingly, a long record retention period for such special elections is not likely to be unduly burdensome, in part because these elections will customarily be maintained as part of a bond transcript.

The regulations, however, provide for (and in some cases require) a number of other special tax actions, many of which are not required to be made on or before the date of issuance.

Recommendation: In general, tax elections and other special tax actions such as allocations should be required to be maintained for the longest record retention period. The guidance project possibly should list such elections and allocations for informational purposes, and note that many such special tax actions will not customarily be included within a bond transcript.

Standards for records relating to economic life of bond-financed property

43. Should the guidance project address record retention requirements relating to bond maturity limitations based on the economic life of financed property?

Discussion: All types of qualified private activity bonds (other than qualified mortgage bonds, qualified veterans' mortgage bonds, and qualified student loan bonds) are subject to the bond maturity limitation set forth in section 147(b) of the Code. In general, the weighted average maturity of a bond issue may not exceed 120% of the reasonably expected economic life of the property financed by the bond issue. This standard also applies indirectly to governmental bonds because it is incorporated into the anti-abuse rules of the arbitrage regulations under section 148 of the Code. Accordingly, records relating to reasonably expected economic life of financed property are material to tax compliance of most types of tax-exempt bond issues.

Recommendation: The guidance project should provide that information relating to economic life is generally required to be maintained during and after a detailed record retention period.

44. Should special record retention standards apply in cases where an issuer assigns an economic life to financed property that is greater than the applicable safe harbor economic life?

Discussion: In most instances, issuers determine reasonably expected economic lives in accordance with "safe harbors", which may be based either on safe harbor mid-point lives published by the Service or on widely accepted industry standards. In some cases, however, issuers assign longer lives to property based on the particular facts and circumstances. In such cases, issuers often obtain reports or opinions of an engineer or other independent professional to support the application of longer economic lives. This practice raises the question whether the use of any such reports or opinions should be subject to special record retention requirements.

Recommendation: No special record retention requirements should apply in cases where an issuer assigns an economic life to bond-financed property that is greater than the applicable safe harbor economic life.

45. Should special record retention standards apply in light of the rule that requires the economic life test to be adjusted by the placed in service date of financed property?

Discussion: Under the bond maturity limitations set forth in section 147(b) of the Code, reasonably expected economic life of bond-financed property is generally required to be determined as of the later of the date on which the bonds are issued and the date on which the bond-financed property is placed in service (or expected to be placed in service). Maintaining the exact placed in service dates of all of the projects financed by an issue, however, can be burdensome for an issuer. Accordingly, many issuers conservatively assume, for purposes of bond maturity limitations, that financed projects placed in service after the date of issuance are placed in service on the date of issuance.

Recommendation: Issuers should not be required to maintain records establishing the exact placed in service date of projects financed with an issue. Issuers should instead be required to maintain records establishing a reasonable range of placed in service dates. If an issuer maintains only records showing a range of placed in service dates for a project, however, it should be required to apply the applicable requirements conservatively by assuming that the project was placed in service on either the first day or last day of the range. On the other hand, for purposes of restrictions on private business use of bond-financed property, which generally are applied based on a measurement period based on reasonably expected economic life, the applicable requirements may in some cases be most conservatively applied by assuming that the bond-financed property is placed in service on the last date in the range.

Form of guidance project and other technical issues

46. What is the best format for a guidance project: a regulation, revenue procedure, Internal Revenue Manual provision or some other form of guidance?

Discussion: Significant published guidance concerning record retention requirements has been set forth in revenue procedures. See, in particular, Rev. Proc. 97-22 and Rev. Proc. 98-25.

To date, the principal public statements made by the Service regarding tax-exempt bond record retention requirements is set forth in “FAQs” posted on the Service’s website, which does not have the status of formal published guidance. Other significant guidance regarding tax-exempt bond administrative procedures has been published in the Internal Revenue Manual.

Recommendation: The guidance should be published in the form of a revenue procedure establishing safe harbors, so that issuers would have assurance that they can rely on the safe harbors. Ability to rely on the guidance may be particularly important because issuers are now commonly required in bond documents to comply with broadly framed record retention covenants.

47. *What are the best models of similar guidance projects to consider in developing this published guidance project?*

Discussion: There appears to be no published guidance establishing record retention requirement “safe harbors” under the Code. Rev. Proc. 97-22 sets forth guidelines on the maintenance of books and records under an electronic storage system. Rev. Proc. 98-25 sets forth requirements for the maintenance of taxpayer records with an automatic data processing system. Both of these revenue procedures, however, purport to set forth record retention requirements rather than safe harbors.

A number of revenue procedures set forth safe harbors under the provisions of the Code that apply to tax-exempt bonds, including Rev. Proc. 97-13 (which sets forth safe harbors relating to whether service contracts result in private business use of tax-exempt bond-financed property) and Rev. Proc. 2007-47 (which sets forth safe harbors relating to whether research agreements result in private business use of tax-exempt bond-financed property).

Recommendation: The published guidance should draw upon certain elements of the record retention safe harbors referenced above and certain of the revenue procedure safe harbors that concern tax-exempt bond requirements, such as Rev. Proc. 97-13, as amended.

48. *Should the published guidance supersede the existing limited requirements on record retention set forth in the regulations?*

Discussion: The 2005 Act Report and the NABL Public Comments (at pp. 2-3) discuss at some length the existing limited requirements on record retention set forth in the tax-exempt bond regulations. For the most part, these limited provisions set forth requirements that certain elections and allocations be maintained in the books and records for an issue. The regulatory safe harbor in 1.148-5(d)(6)(iii)(E) for determining whether guaranteed investment contracts and investments for yield restricted defeasance escrows are acquired at fair market value, however, sets forth detailed record retention requirements.

Recommendation: The guidance project should not supersede the detailed record retention requirements set forth in the regulations for the safe harbor for determining whether guaranteed investment contracts and investments for yield restricted defeasance escrows are acquired at fair market value.

49. Should the guidance project provide that the Service will entertain closing agreements on different types of record retention procedures?

Discussion: Tax-exempt bond issuers and borrowers have a wide variety of record retention practices, organizational structures and administrative resources. In that light, it is likely that no safe harbor will be able to adequately address all of the special circumstances that apply to issuers and borrowers.

In Notice 2004-11, the Service established a recordkeeping agreement pilot program relating to taxpayers claiming the research credit. The 2005 Act Report specifically recommended extension of such an approach to record retention requirements for tax-exempt bonds.

Recommendations: The guidance project should establish a pilot program for bond “recordkeeping agreements”, informed by the model of Notice 2004-11. In general, the pilot program should indicate that the Service generally intends that safe harbor record retention practices will be conditioned on the adoption and implementation of reasonable bond compliance procedures meeting the core elements specified in the bond record retention guidance project.

50. Should the guidance project have prospective application only?

Discussion: Because the guidance project would provide safe harbors, rather than set forth substantive interpretations, there appears to be no reason to prevent an issuer from applying the guidance project to any issue, regardless of when issued. Certain requirements of the safe harbor as contemplated by this Issues Memorandum, however, raise effective date and transition rule questions. In particular, the possible requirement that all bonds of a particular category must meet the safe harbor for any to meet the safe harbor raises effective date questions.

Recommendation: The application of the requirements of the safe harbor should generally be prospective, in the sense that the “all or nothing” rule for particular categories of bonds should only apply to bonds issued after the date of publication of the guidance project.

51. Should the guidance project include transitional rules for outstanding bond issues (for example, for good faith reconstruction of records in cases where records are no longer available)?

Discussion: The development of flexible transition rules is essential for making the guidance project most useful. Issuers are currently faced with the administrative burden of record retention for outstanding bond issues. At least for the next several years, that administrative burden will be substantially greater for bonds issued before the effective date of the guidance project, because the then-outstanding bond issues will in many cases outnumber new bond issues.

One approach would be to permit an issuer to apply the safe harbors to any bonds issued before the effective date without any limitation, or perhaps with the limitation that the issuer also consistently meets the safe harbor requirements for all bonds of that category issued after the effective date. A somewhat different approach would be to permit an issuer to apply the safe harbors to bonds issued before the effective date, provided that the issuer consistently applies the qualifying reasonable bond compliance procedures to all bonds of that category issued after an identified transitional date.

One possible transition approach would be to follow the transition rule for detailed private use reporting set forth in Schedule K to the new Form 990. Schedule K generally requires detailed private use reporting for new money bonds (that is, bonds that are not refunding bonds) issued after December 31, 2002. A transition rule modeled on this approach could permit an issuer to apply the safe harbors to any bonds issued prior to the effective date of the guidance project, provided that the issuer consistently applied the guidance project to all new money bonds of the same category issued after 2002. Other possible transition dates for such a rule would be May 16, 1997 (the effective date of comprehensive private activity bond regulations) or December 19, 2005 (the transition date set forth in comprehensive private activity bond regulations relating to refundings).

Recommendation: Flexible transition rules should be provided that encourage issuers to make good faith efforts to bring outstanding bond issues into compliance with the safe harbor requirements.

Special standards for conduit bond issues

52. *Should the guidance project require certain records to be retained by the governmental issuer and certain records to be retained by the conduit borrower, as conditions for eligibility for record retention safe harbors?*

Discussion: Neither the Code nor the regulations specify whether the governmental issuer or conduit borrower is required to retain particular types of records. Commonly, bond documents provide that the conduit borrower has primary responsibility for post-issuance compliance. The conduit borrower is required, however, to participate in certain post-issuance matters, including the filing of information returns and making certain elections.

The 2005 Act Report (at p. 9) recommends that guidance is needed regarding whether a conduit borrower, the governmental issuer, or another party is required to maintain certain types of records.

The NAHEFA/NCHFFA Public Comments (at p. 3) recommend guidance on which records are required to be maintained by the conduit issuer and the conduit borrower. Those public comments recommend that, for example, the issuer of conduit bonds should be required to maintain the bond transcripts and

documents to which the issuer is party and the conduit borrower (or a designated third party) should be required to maintain the investment and expenditure records on the use of the bond proceeds.

Recommendation: The guidance project should not require that any particular records be maintained by the governmental issuer rather than the conduit borrower, but rather should require that responsibility for record retention tasks should be clearly identified.

53. Should only the conduit borrower, and not the governmental issuer, be required to adopt reasonable bond compliance procedures as a condition for eligibility for record retention safe harbors?

Discussion: In the case of most conduit bond issues, the bond documents assign the responsibility for post-issuance compliance to the conduit borrower. The Code and applicable regulations place certain compliance responsibilities on the governmental issuer, including making certain elections and identifications, executing information returns, and (in some cases) making public approvals after holding public hearings.

In addition, conduit bond issues include both issues with a single conduit borrower and pooled financing bonds with multiple conduit borrowers. In the case of pooled financing bonds, a number of special requirements apply (for example, under section 149(f) of the Code).

Recommendation: The guidance project should provide that in general the conduit borrower, and not the governmental issuer, is required to adopt reasonable bond compliance procedures as a condition for eligibility for record retention safe harbors. The guidance project should contemplate, however, that conduit issuers of pooled financing bonds need to adopt comparable procedures relating to the special requirements for pooled financing bonds in order to be eligible for the safe harbors.

54. Should the conduit borrower be required to demonstrate to the governmental issuer that it has adopted and implemented reasonable bond compliance procedures as a condition for eligibility for record retention safe harbors?

Discussion: The tax compliance role of governmental issuers of conduit bonds varies greatly. There appears to be no standard industry standard or best practice defining the tax compliance role of conduit issuers. Many conduit issuers expressly disclaim responsibility for post-issuance compliance in bond documents.

On the other hand, the Code and regulations contemplate that conduit issuers are required to perform at least some post-issuance compliance functions. For example, conduit issuers are generally required to sign information returns,

identify qualified hedges for arbitrage purposes, and to act as taxpayer in connection with bond examinations and voluntary closing agreements.

Recommendation: A conduit borrower should be required to certify to the governmental issuer in the books and records for a bond issue that it has adopted and implemented reasonable bond compliance procedures as a condition for eligibility for record retention safe harbors.

Conduit borrowers should also be required to certify, on a periodic basis, that it continues to implement reasonable bond compliance procedures as a condition for continued eligibility for record retention safe harbors. Such a certification should not be required to be in any particular form, however, and may be met by a general compliance certification.

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APPENDIX C

PROPOSED FORM OF REVENUE PROCEDURE

Rev. Proc. 2009-__

Records Establishing Compliance with Certain Requirements of Sections 103, 141 through 150, 54AA, 54F and 1400U-2

Section 1. Purpose

The purpose of this revenue procedure is to set forth conditions under which certain factual and other matters material to the requirements of §§ 103, 141 through 150, 54AA, 54(f) and 1400U-2 of the Internal Revenue Code of 1986 (the Code) will be considered by the Service to be established. This revenue procedure does not set forth substantive standards for recordkeeping requirements under § 6001. This revenue procedure is intended to provide administrative relief to issuers and conduit borrowers of tax-advantaged bonds. The failure of an issuer or conduit borrower to adopt the safe harbors set forth in this revenue procedure will not establish any presumption adverse to an issuer or conduit borrower in an examination.

Section 2. Background

.01 Requirements for state and local obligations under §§103 and 141 through 150 of the Code

(1) Under section 103(a) of the Code, gross income does not include interest on any State or local bond. Under § 103(b)(1), § 103(a) does not apply to a private activity bond, unless it is a qualified bond under § 141(e). Under § 141(e), a private activity bond is a qualified bond only if it meets the applicable requirements of §§ 142 through 147. Under § 103(b)(2), § 103 does not apply to any arbitrage bond within the meaning of § 148. Under § 103(b)(3), § 103(a) does not apply to any bond unless such bond meets the requirements of § 149.

(2) Many of the requirements of §§ 103 and 141 through 150 apply to an issue on the date of issuance and after the date of issuance throughout the term of the issue. In most instances, failure to comply with such requirements results in interest on the obligations becoming includible in gross income from the date of issuance. In part because obligations issued under § 103 commonly may have maturities in excess of 30 years and may finance a large number of different projects, record retention requirements relating to such requirements may be unusually burdensome.

(3) The issuer (or conduit borrower) of obligations issued under § 103 may covenant to the holders of the obligations to meet the applicable requirements

under §§ 103 and 141 through 150, and will customarily have control of records relating to compliance.

.02 Requirements for Build America Bonds under § 54AA of the Code

(1) Under § 54AA(a) of the Code if a taxpayer holds a Build America Bonds on one or more interest payment dates during any taxable year, there shall be allowed as a credit against income tax for the taxable year an amount equal to the sum of the credits determined under § 54AA(b) with respect to such dates. The amount of the credit determined under § 54AA(b) with respect to any interest payment date for a Build America Bond is 35 percent of the interest payable by the issuer with respect to such date. Under § 54AA(d) of the Code, for purposes of § 54AA, the term “Build America Bond” generally means any obligation (other than a private activity bond) if the interest on such obligation would (but for § 54AA) be excludable from gross income under § 103, such obligation is issued before the date designated therein, and the issuer makes an irrevocable election to have § 54AA apply.

(2) Under § 6431, in the case of any Qualified Build America Bond issued under § 54AA(g) before January 1, 2011, the issuer shall be allowed a credit with respect to each interest payment under such bond in an amount equal to 35 percent of the interest payable under such bond. Under § 54AA(g), the term “Qualified Build America Bond” generally means any Build America Bond if 100 percent of the available project proceeds are to be used for capital expenditures and the issuer makes an irrevocable election to have § 54AA(g) apply.

.03 Requirements for Economic Development Recovery Zone Bonds under § 1400U-2 of the Code.

(1) Under § 1400U-2 of the Code, a Recovery Zone Economic Development Bond is treated as a Build America Bond and a Qualified Build America Bond, provided that a tax credit amount of 45 percent of interest payable applies rather than a 35 percent tax credit. The term “Recovery Zone Economic Development Bonds” generally means a bond 100 percent of the available project proceeds of which are used for the purposes of promoting development or other economic activity in a recovery zone.

.04 Application of recordkeeping requirements

(1) Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, must keep such records, render such statements, make such returns, and comply with such rules as the Secretary may from time to time prescribe. Whenever necessary, the Secretary may require any person, by notice served upon that person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not that person is liable for tax.

(2) Section 1.6001-1(a) generally provides that persons subject to income tax, or required to file a return of information with respect to income, must keep such books or records as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by that person in any return of such tax information.

(3) Section 1.6001-1(e) provides that the books or records required by § 6001 must be kept available at all times for inspection by authorized internal revenue officers or employees, and must be retained as the contents thereof may become material in the administration of any internal revenue law.

Section 3. Safe harbor bond compliance procedures

01. *Safe harbor bond compliance procedures* mean reasonable procedures adopted and implemented by an issuer that are intended to ensure compliance with the applicable requirements of §§ 103, 141 through 150, 54, 54A, and 54AA and that include at least all of the following elements—

(1) Reasonable procedures to assign compliance responsibilities to appropriate departments, employees, or other functions;

(2) Reasonable procedures for the establishment and maintenance of books and records files for each issue;

(3) Reasonable procedures for compliant investment of gross proceeds for each bond issue;

(4) Reasonable procedures for the review and allocation of expenditures of bond proceeds for each issue;

(5) Reasonable procedures for periodic monitoring of use of proceeds and financed property; and

(6) Susceptibility to audit to verify adherence to the procedures.

02. *Reasonable procedures for assignment of compliance responsibilities* mean procedures that identify and assign responsibility for each of the Bond Requirements that apply to each Category of Bond Issue. The specific manner in which the assignment is made may take into account the size and organizational structure of the issuer, the size and complexity of the issues of tax-exempt bonds and tax credit bonds that are issued by the issuer, the nature of the Bond Requirements that are applicable, and other relevant facts and circumstances that apply to the issuer and its obligations.

The following are examples of reasonable procedures for assignment of compliance responsibilities.

(1) *Example 1.* City A seeks to adopt and implement safe harbor bond compliance procedures for its general obligation bonds. Under the City A's charter, the chief financial officer generally has responsibility for financial matters, the city attorney has responsibility for legal interpretation, and the city treasurer has responsibility for investment of funds. City A adopts tax-exempt bond compliance policies that assign to these officers specific compliance tasks. For example, in general, the chief financial officer is assigned responsibility to review how bond proceeds are spent, to maintain records relating to expenditures, and to compute the amount of any private business use of bond proceeds. The city attorney is assigned responsibility to review any contractual arrangements for use of bond-financed property and to maintain records relating to any such arrangements. The treasurer is assigned responsibility to ensure that all investments purchased with tax-exempt bonds are purchased and sold at fair market value, that reports relating to the rebate requirement of § 148 are obtained on a timely basis, that any required rebate payments are made to the United States on a timely basis, and that records relating to such investments are retained. Such an approach, if implemented for each specific material requirement, may meet the requirement for reasonable procedures for assignment of compliance responsibilities.

(2) *Example 2.* Health Care Organization H is an organization described in § 501(c)(3) that owns and operates five hospitals. The general counsel of H also serves as the assistant treasurer. H seeks to adopt safe harbor bond compliance procedures for its hospital revenue bonds. H determines to appoint the general counsel/assistant treasurer as “bond compliance officer” and to assign all tax-exempt bond compliance responsibilities to the bond compliance officer, with the exception of record retention requirements relating to expenditures of bond proceeds, which are to be maintained at the hospital level. Such an approach, if implemented for each specific material requirement, may meet the requirement for reasonable procedures for assignment of compliance responsibilities.

03. *Reasonable procedures for the establishment and maintenance of books and records files* mean procedures that identify different categories of material records of each issue that may be created both on or before the date of issuance and throughout the term of the issue, that identify the location where each category of records will be retained and that identify the department, employees or function responsible for maintaining each category of material records. In most cases, procedures for the establishment of books and records files will not be reasonable if the books and records files consist only of records available as of the date of issuance (for example, only the bond transcript). Procedures for the maintenance of books and files are reasonable only if all elections required or permitted under the Code or Income Tax Regulations for an issue are maintained for the General Record Retention Period. An important factor in determining whether books and records files are reasonable is whether the files are designated in a manner that identifies and takes into account treatment of bonds as different issues for purposes of the Bond Requirements (which may be different than the identification of bonds as different issues for state law or bond document requirements.)

Example. City A seeks to adopt safe harbor compliance procedures for its general obligation bonds. City A adopts compliance procedures that identify the following files of books and records for each of its general obligation bond issues, that specify the location of each such file and that identify a department responsible for maintaining each file:

- (1) The bond transcript.
- (2) Requisitions to the bond trustee.
- (3) Other information showing how the bond proceeds are spent, which may include invoices and checks or other verifiable information.
- (4) Records showing actual payments of debt service on the issue.
- (5) The bond proceeds expenditure certificate and other post-issuance tax allocations and elections, if any.
- (6) Records of all investments of bond proceeds and any other “gross proceeds” of the bonds, including rebate reports and evidence of rebate payments.
- (7) Records establishing the use of all property financed with proceeds of the bond issue, including service contracts and leases.
- (8) Records, certifications, and opinions relating to any “change of use” of bond-financed property, including remedial action certificates and opinions.
- (9) Records relating to extensions or replacements of guarantees of bonds of the issue, such as letters of credit, and records showing the dates and amounts of any payments for guarantees.
- (10) Records relating to interest rate swaps or other derivatives relating to the bonds entered into after the date of issuance, if any, and records showing the dates and amounts of any payments and receipts with respect to each derivative contract.
- (11) Records relating to any modifications of the bonds or the bond documents of the bond issue, including amendments to bond documents and interest rate mode conversions.

These different categories of records will be maintained at varying different locations by a number of different responsible officials or departments. City A has adopted reasonable procedures establishing books and records files for its general obligation bonds.

04. *Reasonable procedures for compliant investment of gross proceeds* means reasonable procedures that are intended to ensure that the investment of gross proceeds meets the arbitrage requirements of § 148 and the federal guarantee requirements of § 149(b) including at least the following elements –

(1) Procedures to ensure that all such investments are purchased and sold at fair market value in bona fide, arm's-length transactions;

(2) Procedures to ensure that all such investments that are guaranteed investment contracts or investments for a yield restricted defeasance escrow are purchased and sold pursuant to the "three-bid" safe harbor set forth in § 1.148-5(d)(6)(iii), unless application of that safe harbor is determined to be not reasonably practicable. For example, application of the safe harbor may be determined not to be reasonably practicable because of limited interest of potential providers of the investment;

(3) Procedures to ensure that bond proceeds are not intentionally held uninvested and are not actually held uninvested for a period of longer than 3 days;

(4) Procedures to ensure that any required rebate payments are made to the Service on a timely basis;

(5) Procedures to ensure that any funds or accounts that are subject to yield restriction are specifically identified and that yield restriction requirements are met for such funds or accounts, either by means of investment or yield reduction payments;

(6) Procedures to ensure that rebate and yield restriction computations and payments are determined in a manner consistent with the final allocation of proceeds to expenditures;

(7) Procedures to ensure that any funds or accounts that are treated as containing gross proceeds of the issue, but which are not directly funded with proceeds of the issue (for example, any "sinking funds" or "pledged funds" that are treated as "replacement proceeds"), are specifically identified for review for compliance with investment restrictions.

05. *Reasonable procedures for the review and allocation of expenditures of proceeds.*

(1) *In general. Reasonable procedures for the review and allocation of expenditures of bond proceeds* mean reasonable procedures that are intended to ensure that bond proceeds are used for qualifying expenditures including at least the following elements--

(a) Review to confirm that each amount treated as an expenditure was a cash outlay to an unrelated party to the issuer;

(b) Review to confirm that each amount for a working capital expenditure is permitted under applicable restrictions of the Code and regulations (for example, is permitted under the “proceeds-spent-last” rule for working capital expenditures in § 1.148-6(d) or the limitation on financing working capital expenditures with available project proceeds of §§ 54AA);

(c) Review to confirm that each amount treated as an expenditure did not involve a noncustomary prepayment (that is, a prepayment that would give rise to investment property because it is noncustomary);

(d) Review to confirm that the final determination of how bond proceeds are spent is consistent with the qualified use requirements that apply to the issue, including any applicable restrictions on financing issuance costs;

(e) In the case of qualified 501(c)(3) bonds, review to confirm that the final determination of how bond proceeds are spent is consistent with the public approval of the issue;

(f) Review to confirm that the final determination of how bond proceeds are spent is consistent with any restrictions on the minimum weighted average maturity of the capital expenditure property financed with proceeds of the bonds set forth in the Code or applicable federal income tax regulations; and

(g) Review to confirm that the method for allocating proceeds to expenditures, if different than a specific tracing method, is stated.

(2) *Procedure for execution of a final proceeds expenditure allocation certificate.* Under §§ 1.141-6 and 1.145-2 allocations to expenditures generally may be made using any reasonable, consistently applied accounting method. The adoption and implementation of a procedure requiring the execution of a final proceeds expenditure allocation certificate within the time period required by applicable regulations is a strong factor in establishing that procedures for the final review and allocation of bond proceeds is reasonable. In general, issuers may allocate proceeds to expenditures for a period ending 18 months after the financed project is placed in service, as further set forth in § 1.148-6(d).

06. *Reasonable procedures for periodic monitoring of use of financed property.*

(1) *Reasonable procedures for periodic monitoring of use of financed property* mean reasonable procedures that are intended to ensure that use of bond-financed property meets the applicable use-of-proceeds requirements including at least the following elements –

(a) Procedures to ensure that each contract for use of bond-financed property is reviewed for compliance with the applicable qualified use requirements by an employee knowledgeable the applicable legal standards (for example, the legal standards for service contracts set forth in Rev. Proc. 97-13, as amended), before the contract is entered into or renewed;

(b) Procedures to monitor and measure the actual percentage amount of nonqualified use during the period bonds of an issue are outstanding;

(c) Procedures requiring the implementation of a remedial action permitted under applicable regulations, or the submission of a voluntary closing agreement request to the Service, promptly after noncompliance with the applicable qualified use requirements is identified, including policies devoting sufficient resources to implementing remedial actions or making voluntary closing agreement requests, as may be required; and

(d) Procedures for periodic training of employees responsible for periodic monitoring in the types of actions that can result in nonqualified use of bond-financed property, in the availability of remedial actions and voluntary closing agreement requests to correct nonqualified use, and in the applicable legal standards for determining whether a contract for use of bond-financed property results in qualified use or nonqualified use.

(2) *Examples.* The following are examples of reasonable procedures relating to the periodic monitoring of use of financed property.

Example 1. State C seeks to adopt reasonable procedures for the periodic monitoring of use of financed property of its general obligation bonds. In order to simplify the administrative burden of compliance review and record retention, State C adopts the following conservative conventions. State C's procedures generally require that the amount private business use of proceeds of any bond issue will not be permitted to exceed the lesser of 5 percent or \$15,000,000, even though a 10 percent limitation applies in most cases under § 141, except in the case of unrelated or disproportionate private business use. In the case of bond issues to which this conservative procedure is applied, State C does not retain any books and records sufficient to determine whether any private business use is unrelated or disproportionate. State C's procedures also provide, however, that the amount of private business use of a bond issue may be permitted to exceed 5 percent, provided that the attorney within the Attorney General's office knowledgeable in the applicable private activity bond rules makes a special review of any private use arrangements to determine whether they result in unrelated or disproportionate use, and State C maintains records sufficient to establish whether any private use is treated as unrelated or disproportionate. This is a reasonable procedure relating to the periodic monitoring of financed property.

Example 2. District D seeks to adopt reasonable procedures for the periodic monitoring of use of financed property of its water revenue bonds. In order to simplify the administrative burden of compliance review and record retention, District D adopts the following conservative conventions. District D's procedures generally require that the amount of private business use of proceeds will not be permitted to exceed the lesser of 10 percent or \$15,000,000 determined on an annual basis, even though measuring private business use on an average basis over a measurement term which may be as long as the term of a bond issue is

generally permitted. Because of the nature of the projects financed by District D (for example, water plants), District D is able to determine with a high degree of confidence for each issue that no use of financed property that results in private business use would be treated as unrelated or disproportionate use. District D's procedures require that its finance director must monitor private business use of the property financed by each issue on an annual basis to determine with a high degree of confidence that that amount does not exceed the permitted limit, but do not require a computation of the exact amount of private business use. For purposes of determining the amount of private business use in prior years during the term of an issue, District D conservatively assumes that the amount of private business use was the maximum permitted amount, so that District D does not benefit from the rule that permits private business use to be determined on an average basis over a measurement term. This is a reasonable procedure relating to the periodic monitoring of financed property.

07. *Reasonable susceptibility to audit* means that procedures are set forth in written form in a manner that is reasonably susceptible to either internal or external audit to determine whether the employees, departments, or functions of the issuer that are identified as responsible for specific compliance task responsibilities have met those responsibilities on a timely basis. The requirement of reasonable susceptibility to audit does not require that compliance with the procedures be actually audited by an internal or external auditor at any specific intervals.

Section 4. Other Definitions

01. *Bond* means an obligation of a State or local government that is intended to be an obligation the interest on which is excludable from gross income under § 103, a qualified tax credit bond under § 54A(d), a Build American Bond under § 54AA, or a Recovery Zone Economic Development Bond under § 1400U-2.

02. *Bond Requirements* means the requirements of §§ 103, 141 through 150, 54, 54A, 54AA, and 1400U-2 that apply to an issue.

03. *Category of Bonds* generally means a type of Bonds subject to substantially the same requirements under the Code. For example, each of the following is a different Category of Bonds: qualified 501(c)(3) bonds issued under § 145; qualified mortgage revenue bonds issued under § 143; and each different type of exempt facility bond issued under § 142. Bonds are not treated as different Categories, however, merely because they may be subject to different regulations or other published guidance or are subject to different amended versions of the same subsection of the Code.

In the case of Governmental Bonds, an issuer may in addition chose to treat different types of obligations issued under substantially different State law authority as different Categories of Bonds. For example, an issuer may determine to treat each of general obligation bonds, water and sewer revenue bonds, and tax increment bonds as a different Category of Bonds.

04. *Conduit Borrower* is defined in § 1.150-1(b) and generally means the obligor on a purpose investment.

05. *Conduit Financing Issue* is defined in § 1.150-1(b) and generally means an issue the proceeds of which are used or are reasonably expected to be used to finance at least one purpose investment representing at least one conduit loan to one Conduit Borrower.

06. *Conduit Financing Issuer* means the actual issuer of a Conduit Financing Issue.

07. *Detailed Records of Expenditures* generally mean detailed records of all expenditures of proceeds of an issue including at least the following information: (1) the amount of each expenditure; (2) information sufficient to identify the separate project or purpose of each expenditure; (3) identification of the specific unrelated party (for example, the vendor or contractor) receiving the payment; (4) the date of the expenditure on which the expenditure was made; (5) except as provided by this section, the reasonably expected weighted average maturity of each separate project or purpose; and (6) the placed in service date of each separate project or purpose that is a capital expenditure. In general, detailed records of expenditures include invoices and checks. Detailed Records of Expenditures may include records relating to equity contributions to projects financed with proceeds.

In the case of proceeds used for working capital purposes subject to the “proceeds-spent-last” rule in § 1.148-6(d)(3), Detailed Records of Expenditures include cash flow statements, financial statements and other records reasonably sufficient to establish the amount of the deficit amount material to determining whether proceeds are treated as expended.

08. *Detailed Records of Investments* means detailed records all investments of gross proceeds of an issue generally including the following information: (a) purchase price (including the amount of accrued interest stated separately); (b) nominal rate of interest; (c) par or face amount; (d) purchase date; (e) maturity date; (f) amount or original discount or premium (if any); (g) general type of investment; (h) frequency of periodic payments (and actual dates and amounts of receipts); (i) period of compounding; (j) date of disposition; (k) amount realized on disposition (including the amount of accrued interest stated separately); (l) in the case of guaranteed investment contracts and yield restricted defeasance escrow investments, transaction costs (e.g., commissions) incurred in acquiring, carrying, or disposing of the investments; and (m) if an investment is not traded on an established securities market, such as a guaranteed investment contract, or in a yield restricted escrow, market price data sufficient to establish that the purchase price (or disposition price) was not greater than (or less than) the arm’s-length fair market value on the date of acquisition (or disposition) or, if earlier, on the date of a binding contract to acquire (or dispose of) the investment.

09. *Detailed Records of Use Arrangements* means detailed records of all arrangements for use of proceeds and property financed by an issue, including copies of all contracts for use of bond-financed property that may result in nonqualified use. In the case of a governmental bond, Detailed Records of Use Arrangements do not need to include records of arrangements that are general public use or of contracts for services that are solely incidental to the primary governmental function of the bond-financed property. In the case of a qualified 501(c)(3) bond, Detailed Records of Use Arrangements need to include records sufficient to determine whether the bond-financed property is used for an unrelated trade or business, regardless of the term of an arrangement.

Example. County E issues general obligation bonds to finance a parking garage, which are intended to be tax-exempt governmental bonds. County E enters into the following types of contracts for use of the parking garage: (a) a service contract for management of the parking facility; (b) a janitorial contract for the parking garage office; and (c) monthly contracts for use of parking spaces, which are offered to the general public on the basis of rates that are generally applicable and uniformly applied. In connection with the issuance of the bonds, County E was advised by bond counsel that contracts of the nature of the janitorial contract was incidental to the primary governmental function of the parking garage and that arrangements of the nature of the monthly parking contracts were general public use arrangements. The Detailed Records of Use Arrangements for this issue of bonds are required to include the management contract for operation of the parking garage, but not the janitorial contract or the monthly parking contracts.

10. *General Record Retention Period* generally means the period ending on the date that is three years after the last bond of an issue is retired.

11. *Governmental Bond* means an obligation issued under § 103 of the Code that is not a private activity bond under § 141, a Build America Bond issued under § 54AA, and a Recovery Zone Economic Development Bond issued under § 1400U-2.

12. *Issuer* generally means the entity that actually issues an issue and, unless the context or a provision clearly requires otherwise, each conduit borrower for the issue.

13. *Minimum Detailed Record Retention Period* means a period that is the shorter of (1) six years after the relevant action or event to which a record relates and (2) the General Record Retention Period. In the case of records relating to investments, the Minimum Detailed Record Retention Period generally begins on the date of the applicable payment or receipt. In the case of records relating to expenditures of proceeds, the Minimum Detailed Record Retention Period generally begins not earlier than the date on which proceeds are actually treated as paid to an unrelated person. In the case of records relating to qualified use of bond proceeds or bond-financed property, the Minimum Detailed Record Retention Period generally begins not earlier than the last date on which an arrangement for

use of proceeds or financed property terminates. In the case of records relating to elections required or permitted to be made under the Code or Income Tax Regulations, the Minimum Detailed Record Retention Period is the same as the General Record Retention Period.

14. *Project* means a project as defined for purposes of the allocation and accounting rules under § 141 of the Code, as set forth under § 1.141-6(a). In general, the term project means one or more facilities or capital projects, or other property that meets each of the following requirements: (1) the facilities or capital projects are functionally related or integrated and are located on the same site or reasonably adjacent sites and (2) the facilities or capital projects are reasonably expected to be placed in service within the same 12-month period.

15. *Qualified Use Compliance Certificate* means a certificate executed by a responsible officer for each issue containing the following information for the period covered by the certificate: (1) a list of all contractual arrangements for use of the proceeds or property financed by the issue, including identification of any contractual arrangements resulting in nonqualified use; (2) a certification that all such arrangements have been reviewed to determine whether they result in nonqualified use, and (3) a certification of the total amount of nonqualified use of bond-financed property (as a percentage of proceeds or net proceeds) for the period. In general, for this purpose a responsible officer must be an officer or employee of the issuer with authority to make certifications under state or local law who either is knowledgeable in the types of actions that can result in nonqualified use of bond-financed property, in the availability of remedial actions and voluntary closing agreements to correct nonqualified use, and in the applicable legal standards for determining whether a contract for use of bond-financed property results in qualified use or nonqualified use or has consulted with a person who is knowledgeable in such matters in connection with execution of a Qualified Use Compliance Certificate. For example, a responsible officer may consult with an independent bond counsel or other professional in connection with execution of a Qualified Use Compliance Certificate, but is not required to do so.

A Qualified Use Compliance Certificate may be in any reasonable form, and may be in the form of more than one certificate, provided that all of the required information is set forth. For example, a properly completed Schedule K to Form 990 will meet the requirement for certifications to the effect that all arrangements have been reviewed to determine whether they result in nonqualified use and regarding the amount of nonqualified use of bond-financed property. Accordingly, a Qualified Use Compliance Certificate may consist of a properly completed Schedule K together with a separately maintained list of all contractual arrangements for use of the proceeds of the bond-financed property including an identification of any contractual arrangements resulting in nonqualified use.

In the case of Governmental Bonds, a Qualified Use Compliance Certificate must be completed on a basis not less frequently than the period rebate is or would be due to be paid to the United States under § 148 (for example, not less frequently

than a period 5 years if no special election is made and is all bonds of the issue are not retired during that period).

In the case of Qualified 501(c)(3) Bonds, a Qualified Use Compliance Certificate must be completed on an annual basis and must also include a list of all unrelated trade or business use activities or arrangements resulting in nonqualified use of the bond-financed property.

16. *Refunding Issue* is defined in § 1.150-1(d) and generally means an issue of obligations the proceeds of which are used to pay principal, interest or redemption price on another issue (a prior issue).

17. *Summary Record of Expenditures* means a statement or statements summarizing all expenditures of proceeds of an issue including at least the following information: (1) the amount of expenditure for each separate project or purpose; (2) a description of each separate project or purpose; (3) date of the expenditure or reasonable date range during which the expenditure was made; (4) except as provided by this section, the reasonably expected weighted average maturity of each separate project or purpose; and (5) the placed in service date of each separate project or purpose that is a capital expenditure or reasonable placed in service date range. A Summary Record of Expenditures may include records relating to equity contributions to projects financed with proceeds.

For this purpose, the “project or purpose” of an expenditure must be sufficiently detailed to be the basis of determining whether the issue meets the applicable qualified use of proceeds and bond-financed property restrictions. For example, all capital expenditures for a new building generally may be treated as a single project or purpose if the entire building may be treated as a single project for purposes of the private activity bond restrictions of § 141. In the case of qualified 501(c)(3) bonds, the description of project or purpose of an expenditure must include information sufficient to establish that the project or purpose is within the scope of expenditures permitted under the public approval of the issue. Expenditures for Issuance Costs must be stated as a separate project or purpose. Expenditures for working capital purposes must be stated as a separate project or purpose or separate projects or purposes, as appropriate. Expenditures for qualified guarantee fees must be separately stated.

18. *Summary Records of Investments* means a statement or statements summarizing all investments of gross proceeds of an issue including at least the following information: (1) the amount paid for each investment; (2) the date the payment for each investment is made; (3) the amount each receipt from each investment is made; and (4) the date each receipt is received. A rebate report summarizing investment activity for a period, regardless of whether the rebate report uses the “investment method” showing all reinvestments or the “disbursement method” showing only payments for investments and payments for expenditures is an acceptable Summary Record of Investments.

Section 5. Scope

This revenue procedure applies to obligations of a State or local government that are intended to be an obligations the interest on which is excludable from gross income under § 103 and which are not a private activity bonds under § 141, obligations that are intended to qualify as qualified 501(c)(3) bonds under § 145, obligations that are intended to qualify as Build American Bonds under § 54AA, and obligations that are intended to qualify as a Recovery Zone Economic Development Bonds under § 1400U-2.

Section 6. Operating Guidelines for Safe Harbor Bond Compliance Procedures

01. *In general.* An issuer that has adopted and in good faith implemented all of the safe harbor bond compliance procedures set forth in section 3 of this revenue procedure with respect to any Category of Bonds may conclusively establish the factual and other matters material to compliance with the applicable Bond Requirements described in this section. In general, an issuer may conclusively establish only factual matters under this revenue procedure, except that an issuer may also establish whether prior use of financed property was qualified use as a legal matter by means of a Qualified Use Compliance Certificate. For example, records relating to investments maintained under this revenue procedure will not conclusively establish whether, in the case of a refunding issue, an issuer's determination of transferred proceeds used a method permitted under the applicable regulations.

02. *Service review of qualification.* The general requirement that safe harbor bond compliance procedures must be reasonable is intended to provide issuers with flexibility to meet the substantive requirements of the safe harbor using any reasonable method, taking into account the issuer's particular facts and circumstances. If an issuer in good faith adopts and implements bond compliance procedures that are intended to meet all of the requirements of section 3 of this revenue procedure, the Service ordinarily will not challenge in an examination the conclusive effect of records retained before the date the examination is commenced (in a manner taking into account records required to be maintained during the applicable Minimum Detailed Record Retention Period). The Service may determine in an examination of a bond issue, however, that the bond compliance procedures of an issuer do not meet all of the requirements of section 3 of this revenue procedure and that new records retained after the date of any such determination will not have conclusive effect on a prospective basis, even if an issuer has in good faith adopted and implemented bond compliance procedures.

03. *Investment requirements.* An issuer may conclusively establish the amounts paid and received on investments of gross proceeds of an issue by maintaining a Summary Record of Investments for the issue, provided that the issuer also maintains Detailed Records of Investments of gross proceeds of the issue for at least the Minimum Detailed Record Retention Period. A Summary Record of

Investments will not, however, conclusively establish that investments that are guaranteed investment contracts or yield restricted defeasance escrows were acquired or sold at fair market value.

04. *Bond proceeds expenditure requirements.*

(1) *In general.* An issuer may conclusively establish the expenditure of proceeds of an issue by maintaining a Summary Record of Expenditures for the issue, provided that the issuer also maintains a Detailed Record of Expenditures for the Minimum Detailed Record Retention Period.

(2) *Equity contributions.* An issuer may conclusively establish the amount of equity contributions to a project financed with proceeds in the same manner as the expenditure of proceeds may be established under this revenue procedure.

(3) *De minimis rule.* An issuer may conclusively establish that an amount of proceeds of an issue not exceeding 5 percent of the proceeds of the issue and not exceeding \$250,000 for any project or purpose are expended for a qualified use, provided that the issuer otherwise has adopted and implemented safe harbor bond compliance procedures for the issue and in good faith reasonably believes that the proceeds were expended for a qualified use. Multiple projects or purposes may be eligible for this \$250,000 exception, provided that, in the aggregate, the projects or purposes qualifying for the exception do not exceed 5 percent of the proceeds of the issue.

(4) *Special rule for working capital expenditures.* An issuer may conclusively establish that proceeds of an issue are spent on working capital expenditures that are directly related to capital expenditures financed by the issue to the extent permitted by § 1.148-6(d)(3)(ii)(A)(5) (that is, in general in an amount not exceeding 5 percent of the sale proceeds of the issue) if (a) the issuer reasonably expected on the date of issuance that the amount of working capital expenditures that are so directly related would at least equal the amount treated as expended; and (b) the issuer does not treat the working capital expenditures as made sooner than on a pro rata basis relative to the capital expenditures to which the working capital expenditures are directly related.

05. *Requirements for qualified use of proceeds and financed property.*

(1) *In general.* An issuer may conclusively establish whether the proceeds and property financed by an issue are used for qualified use by maintaining a Qualified Use Compliance Certificate for each relevant period, provided that the issuer also maintains a Detailed Record of Use Arrangements for the applicable Minimum Detailed Record Retention Period. A Qualified Use Compliance Certificate will not, however, conclusively establish whether proceeds and property financed by an issue are used for qualified use with respect to any arrangement if the Service commences an examination of the issue during the Minimum Detailed Record Retention Period for that arrangement. A Qualified Use Compliance Certificate

may be used by an issuer, for example, to determine the average amount of nonqualified use over the applicable measurement period under § 1.141-3(g).

(2) *De minimis rule.* An issuer may conclusively establish that property financed with amount of proceeds of an issue not exceeding 5 percent of the proceeds of the issue and not exceeding \$250,000 for any project or purpose is used for a qualified use, provided that the issuer otherwise has adopted and implemented safe harbor bond compliance procedures for the issue and in good faith reasonably believes that the proceeds were used for a qualified use. Multiple projects or purposes may be eligible for this \$250,000 exception, provided that, in the aggregate, the projects or purposes qualifying for the exception do not exceed 5 percent of the proceeds of the issue.

Section 7. Application to Refunding Issues

01. *In general.* This section sets forth the treatment of records for Refunding Issues under this revenue procedure. Refunding Issues may consist of all of an issue or a portion of a multipurpose issue that refunds all or a portion of a prior issue.

02. *Investment records.* Records relating to investments of gross proceeds of a prior issue are material to compliance of a Refunding Issue only to the extent that those investments become gross proceeds of the Refunding Issue (either as transferred proceeds or as replacement proceeds).

03. *Expenditure records.* Records relating to expenditures of proceeds of a prior issue are material to compliance of a Refunding Issue.

04. *Records of use of bond-financed property.* Records relating to use of property financed with a prior issue are material to compliance of a Refunding Issue to the extent that such prior use is material for determining whether the combined issue rule set forth in § 1.141-13(b) applies to the Refunding Issue and the prior issue. Accordingly, in general records relating to use of financed property on and after December 19, 2005 and records relating use of financed property after the issue date of prior bonds issued on or after May 16, 1997 are material to compliance of the Refunding Issue.

Section 8. Application to Conduit Financing Issues

01. *In general.* In the case of a conduit financing issue, the different elements of safe harbor bond compliance procedures may be adopted and implemented either by the Conduit Borrower or the Conduit Financing Issuer, provided that the assignment of responsibility is set forth in the books and records for the issue. For example, this requirement is met if the bond documents assign all post-issuance compliance responsibilities to the Conduit Borrower, so that the Conduit Financing Issuer has no record retention obligations. In another example, a Conduit Financing Issuer may assume responsibility for compliant investment of gross proceeds (including compliance with yield restriction and rebate requirements) and

books and records relating to such investments, but not responsibility for other bond compliance procedures. Safe harbor bond compliance procedures may be implemented in this manner provided that the assignment of responsibility is set forth in the books and records for the issue.

02. *Requirement of Conduit Borrower to make certifications to Conduit Financing Issuer regarding adoption and implementation of safe harbor bond compliance procedures.* In the case of a Conduit Financing Issue, a Conduit Borrower will be treated as having adopted and implemented safe harbor bond compliance procedures (or elements of such procedures) only if (1) the Conduit Borrower provides a certification to the Conduit Financing Issuer which are maintained in the books and records for the issue that it has adopted and implemented reasonable bond compliance procedures that are intended to meet the requirements of section 3 of this revenue procedure, and (2) the Conduit Borrower provides periodic certifications to the Conduit Financing Issuer which are maintained in the books and records for the issue to the effect that it has in fact implemented reasonable bond compliance procedures that are intended to meet the requirements of section 3 of this revenue procedure. For this purpose a periodic certification may be provided in intervals of not greater than 5 years and may be in the form of a general bond covenant compliance certificate provided to the Conduit Financing Issuer.

03. *Special requirements for Pooled Financing Bonds.* In the case of Pooled Financing Bonds, a Conduit Financing Issuer must also adopt and implement reasonable procedures that are intended to ensure compliance with the applicable provisions of the Code and the regulations that apply to Pooled Financing Bonds (for example, the requirements of § 149(f)) in order to meet the requirements of section 3 of this revenue procedure.

Section 9. Effect on Other Documents

01. The period permitted for allocating proceeds to expenditures under Treas. Reg. § 1.148-6(d) is extended for certain issues as set forth in section 10 of this revenue procedure. Guidelines published by the Service for maintenance of records under an electronic storage system and maintenance of records with an automated data processing system apply to records maintained under this revenue procedure. See Rev. Proc. 97-22 and Rev. Proc. 98-25.

Section 10. Effective Date and Transition Rules

.01 *General effective date.* This revenue procedure generally applies to bonds issued after [the date of publication of this revenue procedure in the Internal Revenue Bulletin.]

.02 *Elective retroactive application to particular bond issues.* An issuer may apply this revenue procedure to any bonds issued on or before [the date of publication of this revenue procedure in the Internal Revenue Bulletin], provided

that the issuer must consistently apply this revenue procedure at least to all issues of the same Category of Bonds that are issued after December 31, 2002 and before [the date of publication of this revenue procedure in the Internal Revenue Bulletin] and that are not refunding bonds. In the case of a Conduit Financing Issues, the provisions of this section 10.2 apply separately to the same Category of Bonds issued for the benefit of the same Conduit Borrower.

.03 *Special transitional relief for period to determine how bond proceeds are spent.* If an issuer chooses to consistently apply this revenue procedure to all issues of the same Category of Bonds that are issued after December 31, 2002 and before [the date of publication of this revenue procedure in the Internal Revenue Bulletin], the period for making a final allocation of proceeds to expenditures set forth in §§1.141-6(a), 1.148-6(d) and 1.145-2(a) is extended for those issues for a period of one year after [the date of publication of this revenue procedure in the Internal Revenue Bulletin]. In the case of Conduit Financing Issues, the provisions of this section 10.3 apply separately to the same Category of Bonds issued for the benefit of the same Conduit Borrower.

04. *Special transitional rule for Review of Qualified Use and Completion of Qualified Use Compliance Certificates.* If an issuer chooses to apply this revenue procedure as permitted by this section 10 to bonds issued on or before [the date of publication of this revenue procedure in the Internal Revenue Bulletin], the issuer may complete a Qualified Use Compliance Certificate to conclusively establish whether the proceeds and property financed by an issue are used for qualified use in the manner described in section 6.04 of this revenue procedure. The period of time for completing a Qualified Use Compliance Certificate described in section 4.15 of this revenue procedure does not apply to a Qualified Use Compliance Certificate that is completed not later than [date that is one year after the date of publication of this revenue procedure in the Internal Revenue Bulletin], so that the period for completing Qualified Use Compliance Certificates is extended.

**Advisory Committee on
Tax Exempt and Government Entities
(ACT)**

**Federal-State-Local Government
Compliance Verification Checklist
for Public Employers**

Maryann Motza, Project Leader

Steven Hoffman, Project Leader

June 10, 2009

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I. EXECUTIVE SUMMARY

A. Overview of Report

The principal goal of the project undertaken during 2008-2009 by the Federal-State-Local Government (FSLG) Subcommittee of the Internal Revenue Service's (IRS) Advisory Committee on Tax Exempt and Government Entities (TE/GE) (ACT) was to adapt the existing FSLG Compliance Check Form 4318 (see Appendix A) into a self-check form for public (federal, state, and local government) employers [collectively referred to through the remainder of this report as "public employer(s)" unless otherwise noted] to enable them to verify their compliance with applicable federal laws and regulations.

Following testing of the form during 2009-2010, which is intended to be designed to be in a user-friendly format, it is recommended that the form be added to the FSLG Toolkit and accessible to public employers and their legal and financial advisors. See Appendix B for the draft version of the proposed on-line form (Compliance Verification Checklist for federal, State, and Local Governmental Entities) that the ACT developed during 2008-2009.

The ultimate intent of the project is to help public employers know what is expected of them so they can self-correct problems before the IRS initiates a compliance check, examination, or otherwise identifies a compliance problem within a federal, state, or local governmental entity.

B. Principles

The ACT adhered to the following principles while completing this project:

- The adaptation and enhancement of the FSLG Compliance Checklist for use by public employers and their representatives to verify their tax compliance will have an immediate, positive impact on taxpayers.
- The changes made to the existing internally-used FSLG Compliance Checklist and the addition of the revised form to the website will create a "win-win" situation for taxpayers and the IRS vis-à-vis encouraging – and facilitating – voluntary tax compliance. Further, both the U.S. Social Security Administration (SSA) and State Social Security Administrators (State Administrators) will also benefit from a compliance self-verification form such as is proposed. This is because both SSA and State Administrators have integral roles to play¹ in ensuring public employer (particularly state and local

¹ See Chapters 1, 7, and 8, *Federal-State Reference Guide* (IRS Publication 963) for details on the roles and responsibilities of SSA and State Administrators vis-à-vis state and local governments' compliance with the United States Internal Revenue Code and United States Social Security Act and associated regulations and policies

governments) compliance with FICA taxes; Social Security and Medicare coverage and benefits (both voluntary Section 218 Agreement and mandatory Social Security and Medicare coverage); independent contractor reporting, such as Form 1099 filings; worker classification matters; public retirement system requirements; and other tax and coverage-related issues.

C. Recommendations

The ACT recommends that, during 2009-2010, the draft Compliance Verification Checklist for Federal, State, and Local Governmental Entities be "pilot tested" by a number of public employers (of various sizes and types), their stakeholder organizations, the IRS, and the SSA before it is "officially" used by FSLG. The approach would be similar to what TE/GE's Employee Plans Division has done with the Governmental Plans Questionnaire they are currently testing. This approach will help the FSLG Subcommittee to refine the checklist, to determine the level of explanatory information that may be needed within the checklist versus whether or not it would be sufficient to merely have links to publications, and other improvements. Also, the pilot testing and Focus Group "vetting" of the form will serve an additional purpose, i.e., getting stakeholder "buy-in" to the product before it is finalized and officially adopted by the IRS, thus encouraging its broader use after it becomes available on the web.

II. INTRODUCTION AND BACKGROUND

The Office of Federal, State, and Local Governments (FSLG) supports the IRS and the Tax Exempt and Government Entities (TEGE) Division strategic goals of:

1. Enhancing Enforcement of the Tax Law;
2. Taxpayer Education and Outreach; and
3. Modernizing the IRS through its People, Processes and Technology.

In support of these goals, one of the major work plan areas during the 2008-2009 fiscal year for FSLG was to encourage voluntary compliance by government entities.² The advantages of promoting voluntary compliance are obvious for both the IRS and taxpayers.

The complexity of employment taxes, particularly for public employers who have a myriad of voluntary and mandatory exclusions and inclusions to apply on an employee-by-employee basis has been well documented. In 1995, the Colorado State Social Security documented that state and local government employers have **a minimum of 500 possible compliance scenarios** for their employees solely in complying with the federal Social Security and Medicare coverage and benefits and public pension system requirements.³

In its most recent report to Congress, the IRS Oversight Board stated, in blunt terms, that “[t]he main lesson from the Tax Gap Map is that noncompliance is worst where the barriers to voluntary compliance or the opportunities for noncompliance are greatest.”⁴ Certainly the complexity of the tax code is at the core of that problem for all taxpayers, including customers of FSLG.

The National Taxpayer Advocate (NTA), Nina E. Olson, listed that problem as the number one “most serious problems encountered by taxpayers” in her *National Taxpayer Advocate 2008 Annual Report to Congress*. Ms. Olson states:

²FY 2009 FSLG Work Plan, October 1, 2008, http://www.irs.gov/pub/irs-tege/fslg_fy09_work_plan.pdf.

³ M. Motza, “Current/Pending Issues and Coverage Alternatives for the Colorado Public Employees’ Social Security (PESS) Program”, Memorandum to David M. Kaye, Colorado Attorney General’s Office, October 16, 1996.

⁴ *Reducing the Federal Tax Gap - A Report on Improving Voluntary Compliance*, Internal Revenue Service and U.S. Department of the Treasury, August 2, 2007, http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf. *The annual tax gap is the difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time. It services as an overall measure of taxpayer compliance with the tax laws. The most recent estimate of the annual net tax gap is \$290 billion, an amount that the IRS Oversight Board views as unacceptably high. See the IRS Oversight Board Annual Report to Congress 2008, page 3, at: www.irsoversightboard.treas.gov. Also, the phrase “Tax Gap Map” is used to describe the key components of the tax gap and how they relate to one another. See pages 9 and 10 of that report for details and to see the map.*

“The largest source of compliance burdens for taxpayers is the complexity of the tax code. IRS data show that taxpayers and businesses spend 7.6 billion hours a year complying with tax-filing requirements. To place this in context, it would require 3.8 million full-time employees to work 7.6 billion hours. In dollar terms, we estimate that taxpayers spend \$193 billion a year complying with income tax requirements which amounts to 14 percent of aggregate income tax receipts. One count shows the number of words in the tax code has reached 3.7 million, and over the past eight years, changes to the tax code have been made at a rate of more than one a day – including more than 500 changes in 2008 alone. . . . [T]axpayers who honestly seek to comply with the law often make inadvertent errors, causing them either to overpay their tax or to become subject to IRS enforcement action for mistaken underpayments of tax. On the other hand, sophisticated taxpayers often find loopholes that enable them to reduce or eliminate their tax liabilities.”⁵

Even more pertinent to public employers’ tax obligations, the NTA said:

“[T]he overall employment tax compliance rate is high – approximately 88 percent of all employment tax returns are filed and fully paid. While the need to collect unpaid payroll taxes is obvious, the IRS should follow a tailored approach to address the problem, including applying different treatments to taxpayers based on their levels of and reason for noncompliance, encouraging prospective voluntary compliance by helping taxpayers who are attempting to follow complex rules and procedures, concentrating sufficient resources on early intervention techniques to prevent the accumulation of substantial employment tax liabilities, and building on a local compliance presence that balances enforcement with outreach and education.”⁶

The laws and rules that impact public employers’ federal FICA tax obligations include numerous exemptions and exceptions to the laws that apply to the private sector. Further exacerbating the situation are the semantics associated with the laws which can create confusion and inadvertent noncompliance by those employers. For example:

- “Voluntary” Social Security coverage through a Section 218 Agreement was once the only way state and local governments could elect Social Security coverage for their employees. However, since April 20, 1983, coverage under a Section 218 Agreement cannot be terminated unless the governmental entity is legally dissolved.⁷

⁵ *National Taxpayer Advocate -- 2008 Annual Report to Congress, December 31, 2008, page 1, <http://www.irs.gov/advocate/article/0,,id=202276,00.html>.*

⁶ *Id.*, p. 3.

⁷ Public Law 98-21, April 20, 1983, 97 Stat. 65.

- “Mandatory” Social Security coverage⁸ is not really mandatory for all state and local government employees. If a public employer has a qualifying FICA replacement retirement system for its employees, it is not required to pay the Old-Age, Survivor, Disability portion of Social Security. The Medicare-only portion, however, is required for anyone hired by the public employer after March 31, 1986.
- “Mandatory” Medicare coverage is also not really mandatory for all state and local government employees (see above bullet point for employees who must pay Medicare).⁹ It is actually illegal to pay Medicare tax for “Medicare exempt employees”, i.e., those hired prior to April 1, 1986, who have been in continuous employment with the governmental entity since that time, unless a Medicare-only Section 218 Agreement is requested by the public employer and approved by the required number of employees in a referendum election that is held by the State Social Security Administrator.¹⁰

Anecdotal evidence indicates that public employers at all levels of government have little incentive to intentionally be noncompliant with federal taxes. In fact, because all levels of government survive on one or more sources of income from the taxpayers – whether it be property taxes, user fees, sales taxes, income taxes, and so forth – there is actually a greater appreciation for the need to pay proper taxes than may be the case with private sector employers.

That fact has even been documented by the IRS, which shows that Tax Exempt/Government Entities employers, of which FSLG is a component, have the highest overall Voluntary Payment Compliance Rate (VPCR) of 99.87 percent and a Cumulative Payment Compliance Rate (CPCR) of 99.95 percent and 99.97 percent, after one and two years, respectively.¹¹

The advantage of providing easy to understand information and tools to public employers has also been proven by the issuance of IRS Publication 963 (*Federal-State Reference Guide*). Following its initial publication in 1995, Publication 963 was used by the IRS, SSA, and State Administrators as the principal tool for

⁸ Public Law 101-508, November 5, 1990, 104 Stat. 1388 (Omnibus Budget Reconciliation Act of 1990).

⁹ Public Law 99-272, April 7, 1986, 100 Stat. 82 (Consolidated Omnibus Budget Reconciliation Act of 1985).

¹⁰ See Chapter 5, *Federal-State Reference Guide*, Publication 963, for an explanation of Social Security and Medicare coverage requirements for public employers and employees, including when a referendum election must be conducted to obtain Section 218 coverage.

¹¹ *Reducing the Federal Tax Gap - A Report on Improving Voluntary Compliance*, Internal Revenue Service and U.S. Department of the Treasury, August 2, 2007, p. 16, http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf. According to that report, “[t]he Voluntary Compliance Rate (VCR) is the amount of tax for a given tax year that is paid voluntarily and timely, expressed as a percentage of the corresponding amount of tax that the IRS estimates should have been paid. It reflects taxpayers’ compliance with their filing, reporting, and payment obligations. The latest estimate of VCR is 83.7 percent for all taxes and all taxpayers for TY 2001.” (p. 20).

educating state and local government employers about their FICA, Social Security, Medicare, and public pension system obligations. Subsequently, the IRS identified that there was an increase in FICA (representing both Social Security and Medicare taxes) and/or Medicare-only taxes paid to the U.S. Treasury from 1997 through 2000 by public employers/ employees of \$12 billion due solely to the outreach and education intervention that occurred nationwide with the publication and distribution of IRS Publication 963. The additional payments occurred after the *Guide* was first developed, published, and distributed to federal, state, and local governments throughout the country in late 1995.¹²

Thus, it is clear that encouraging and facilitating voluntary compliance by public employers is a cost-effective means of both closing the tax gap as well as reducing the tax burden on taxpayers and the need for enforcement activities by the IRS.

¹² During a January 18, 2001, Hammer Award ceremony, Mr. Dennis Cyr, the Director of the Internal Revenue Service's (IRS) Rocky Mountain District Office-Research and Analysis (DORA), stated that the latest IRS data indicated that issuance and usage of IRS Publication 963, and the associated joint education and outreach program to public employers and their legal and financial advisors, had generated a minimum of an additional \$400 million in Medicare-only revenue from 1997 through 2000. Mr. Cyr indicated that additional revenue for the Social Security and Medicare Trust Funds was attributable to the Project, but, due to the complexity and compliance variability on an employee-by-employee basis, only an approximation of the total could be provided. The Hammer Award was a program directed by then-U.S. Vice President Al Gore that recognized public programs for innovations that improve government efficiency and cost-effectiveness. The award was given to the Public Employers Compliance Strategy Project, a joint endeavor of the IRS, U.S. Social Security Administration (SSA), the Colorado Department of Labor and Employment (CDLE), and the National Conference of State Social Security Administrators (NCSSSA).

In July 2002, the then-Director of Federal-State-Local Governments (FSLG) of the IRS, Mr. Alan Jones, provided an update on the voluntary compliance program's efforts during the NCSSSA's annual conference in Rapid City, South Dakota. Mr. Jones reported that a four year estimate (1997 through 2000) of \$12 billion in both Social Security and Medicare Trust Fund payments were attributable to the IRS, SSA, and State Social Security Administrators' nationwide education and outreach effort that began after the *Federal-State Reference Guide* (IRS Publication 963) was first published in 1995.

III. JUSTIFICATION FOR PROJECT

The FSLG section of the IRS's TE/GE Division uses **Form 4318, Compliance Check** (see Appendix A), when conducting reviews of state and local governments' compliance with all federal laws and regulations that are applicable to public employers. FSLG wants to increase voluntary compliance among public employers and one means to help achieve that goal is to enable them to conduct a "self-check" at any time, using the on-line **Government Entity Toolkit**, <http://www.irs.gov/govt/fslg/article/0,,id=158481,00.html>.

Federal, state, and local governments are a significant labor force in the nation. All three levels of government have numerous employees, with significant payrolls. Many also fund public employee retirement systems that account for a large subset of the economy of the country. For example, the latest U.S. Bureau of the Census data¹³ indicates that there are 89,527 federal, state, and local governments throughout the country. Census data show that, as of 2006, the federal government employed more than 22 million people, with a payroll of more than 74.6 billion dollars, while state and local governments had more than 19.3 million employees, with a payroll of more than 60.7 billion dollars. The Census Bureau projected the 2006 estimate of number of participants in federal retirement systems (excluding Social Security) as totaling over 12.4 million people, with assets totaling more than 1.1 trillion dollars. For the same period, state and local public employee retirement systems were estimated to have nearly 18.5 million participants and nearly three trillion dollars in assets.

The intent of having an on-line form that public employers can use to verify their compliance requirements is to help public employers' know what is expected of them and to self-correct problems before the IRS initiates a compliance check, examination, or otherwise identifies a compliance problem within an entity. This approach is consistent with the Treasury Department and the IRS's goal of improving compliance with the U.S. tax code, including focusing on increasing voluntary compliance as a means to reduce the tax gap.¹⁴

Thus, any tools that can assist public employers with voluntarily complying with the federal law is advantageous to the federal government (particularly the IRS and SSA in their roles in implementing the laws passed by the U.S. Congress), to the public employers and employees themselves, but, most importantly, to the

¹³ *The 2009 Statistical Abstract*, U.S. Bureau of the Census, Table 444 (All Governments – Employment and Payroll by Function: 2006), Table 410 (Number of Governmental Units by Type: 1962 to 2007), and Table 529 (Public Employee Retirement Systems – Participants and Finances: 1980 to 2006), <http://www.census.gov/compendia/statab/>.

¹⁴ For a detailed discussion of the tax gap and plans the Treasury Department and IRS have to address it, go to: *Reducing the Federal Tax Gap - A Report on Improving Voluntary Compliance*, Internal Revenue Service and U.S. Department of the Treasury, August 2, 2007, http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf.

taxpayers and citizens of the U.S. for whom all public employers and employees work, under our federal system of government.

IV. PROCESS

Initial work on the project was divided among the ACT/FSLG members, with each person analyzing and suggesting additions and changes to Form 4318, based on their areas of expertise. All members then did a comprehensive review of the entire draft form that is attached to this report.

The ACT members reviewed existing documentation related to FSLG compliance checks and requirements, including Form 4318, FSLG's case selection criteria, other self-evaluation questionnaires used by TE/GE, IRS Publication 963 (*Federal-State Reference Guide*), the *SSA Handbook*, and other guidelines and resources. The ACT also examined examples of other Compliance Check forms, such as that which is available to Indian Tribal Governments.¹⁵ During this part of the process, the ACT members identified two additional resources that should be added to the FSLG on-line Toolkit:

1. The *Quick Reference Guide for Public Employers* (http://www.irs.gov/pub/irs-tege/public_employers_outreach_guide.pdf).
2. The guide entitled *Retirement Plans for Government Employers* (Appendix C). The IRS already plans to add that guide to its on-line "Retirement Toolkit." A link to the document should also be added to the Employee Plans website as well.

During the initial phases of the process, a conference call was held among the ACT members with Hans Venable, FSLG Specialist, who provided ACT with a clarification of the process used for Form 4318. This conversation was particularly helpful and informative to the ACT members and will provide a solid foundation for the necessary follow-up that is planned during 2009-2010 in order to finalize the self-verification form and process for public employers. The specific information that Mr. Venable provided to the ACT was:

- a. Form 4318 is similar to the Small Business/Self-Employed (SB/SE) compliance check process, but was adapted to the FSLG audience. For example, FSLG customers are exempt from income taxes and are excluded from most excise taxes. Universities/colleges often file additional forms for their affiliates, even if the university/college *per se* is exempt from a particular requirement, e.g., back-up withholding or Form 990 for non-profit reporting.

¹⁵ See, for example, the Indian Tribal Government Compliance Check Report (IRS Form 13797, November 2006, OMB No. 1545-2026), <http://www.irs.gov/pub/irs-pdf/f13797.pdf>. Other compliance checklists that were reviewed included the Exam Check Sheet Questionnaire for IRC 509(a)(3) Supporting Organizations Compliance Project (Project Code # 8001, 8008, or 8127) and the Compliance with IRS Backup Withholding Requirements.

- b. IRS/FSLG staff looks for leads and contact entities where compliance problems may exist.
- c. The IRS examiner completes the existing Form 4318 with the entity either via the phone or in person.
- d. IRS/FSLG conducts compliance checks by market segments.
- e. Compliance checks are conducted only with smaller entities (less than \$2 million annual tax liability and, occasionally, up to \$10 million).
- f. It may be valuable to develop a separate compliance check for larger entities, but that can be validated during the Focus Group and pilot testing period during 2009 - 2010.
- g. No training materials, instructions, or guidelines are currently available for FSLG agents' use in completing the form with entities. IRS Publication 963 (*Federal-State Reference Guide*) is used as the reference guide. [NOTE: ACT/FSLG members have included references and links to appropriate sections of Publication 963 in the revised checklist and accompanying notes and information that are prepared for issuance on the internet as part of the Toolkit.]
- h. Information obtained from the compliance checks are recorded in the IRS database and the form is filed in the entity's case file.
- i. Information obtained from the compliance checks is used to identify education issues needed for that particular entity. They may also issue a discrepancy report to the entity.
- j. FSLG is planning to share the general categories of findings and results of compliance check and examination reports with the public, including State Social Security Administrators. He noted that a recent audit by TIGTA was not happy with FSLG's lack of data sharing to date. FSLG had hoped to provide the information sooner, but were experiencing system problems in doing so.
- k. The IRS does about 855 compliance checks each year. The determination about how many are done is based on managers' asking for a certain number of case orders each year. The decision about which entities to actually conduct compliance checks on is based on querying the database of 941 and 1099 filings to determine if there are any apparent compliance problems. They use 20 case selection criteria. One recent example of a group that has been identified for the compliance check process is 1099 non-filers in government; some may be legitimate non-filers while others may be out of compliance.

ACT members also reviewed the ***Retirement Plans Employment Tax Guide (Guide)*** which was updated by the IRS and Treasury Counsel during 2008-2009. The guide was modified by the IRS and Treasury Counsel to permit its use by the public and will be posted on the IRS website in the “Retirement Toolkit.” The new guide, entitled ***Retirement Plans for Government Employers***, is included with this report as Appendix C. As with the existing FSLG Compliance Check form, the guide has not been readily available to public employers in the past. Because the Compliance Checklist includes retirement plan issues, it is important to ensure consistency between the guide and Form 4318, Form SS-8, and SSA Form 1945. The pilot testing process that will occur during 2009-2010 will include ensuring that consistency.

Following the research period, noted above, the ACT members adapted the FSLG Compliance Check Form 4318, which is currently only available to FSLG staff, into a self-check, user-friendly format that can eventually be included in the FSLG Toolkit and accessible to public employers or their representatives. A pilot testing period of the self-check form is planned by the ACT during 2009 – 2010, during which time suggestions for improvement to the form will be solicited and incorporated.

The project also involved ACT members enhancing or otherwise expanding the content of Form 4318 to include additional information, as necessary and appropriate. For example, the existing Form 4318 does not include questions about what constitutes a qualifying FICA replacement plan, Medicare-only coverage issues and Medicare exclusion, and forms that some public employers must file, such as Form 990, SS-8, and SSA Form 1945. The goal of doing so is to ensure a “one-stop-shop” for federal law compliance for public employers on all of their employment tax, Social Security, Medicare, and public retirement system requirements.

The Indian Tribal Governments’ Form 13797, Compliance Check Report, was used as the model to improve the existing format of the FSLG Compliance Check form. ACT members even included applicable aspects of Form 13797 in the revised Form 4318. ACT members also designed the proposed on-line form to include techniques that make it easier to use and provide better direction to the end-user about what information is being sought, such as drop-down boxes, summary explanations of the legal requirements associated with each question, and links to appropriate forms, publications, and other information currently available on the Internet or which should be posted there in the future.

Due to the complexity of the federal laws that apply to public employers, it is difficult to simplify a form to enable many employers to do a compliance verification of their activities without including additional explanatory information. This problem is particularly acute for less experienced and smaller employers who often have only part-time staff preparing their employment taxes. However, even larger public

employers who are sophisticated and knowledgeable about some aspects of the law may not be as well versed in other portions of the myriad of tax and Social Security and Medicare laws that apply to them.

As a result, the ACT decided it would be meaningless to just ask employers a series of questions, without giving them a frame of reference to self-verify their compliance with the various requirements. The ACT initially tried just putting in links to information, but after discussing it with some colleagues who work with public employers, the ACT came to the conclusion that it might discourage many people from really verifying their compliance level, thus negating the positive effects of doing a self-verification of compliance. Unfortunately, the ACT is concerned that many of the people who could benefit most from the self-verification process will be deterred from using it if they have to link to publications, enter the keywords for the information they need to answer a particular question, search for the answer, then return to the form. Thus, the ACT tried to find a middle-ground. The ACT included links to key reference materials, but also, where issues get complex and nuanced (as they do with so many aspects of Social Security and Medicare coverage and benefits and employment tax laws as they apply to public employers), the ACT put in a brief description of the applicable legal requirement.

The ACT recognize the need to keep the form as brief as possible while still making sure it can be a meaningful tool for self-verification purposes. To achieve that balance, the ACT proposes extending this project into 2009-2010 so the ACT can pilot test the form and conduct focus groups with representatives of various types and sizes of public employers at all levels of government. During this “testing period”, the ACT would also ask for input from stakeholder groups, such as the National Conference of State Social Security Administrators (NCSSSA), Government Finance Officers Association (GFOA), and other similar organizations, as well as by officials in both the IRS and SSA.

When this project was first discussed, then-FSLG Director, Ms. Sunita Lough, indicated she would like to include the option for entities to go on-line and complete the Compliance Checklist themselves. If problems are identified, she indicated she would like to offer them the opportunity to enter into a voluntary closing agreement, including no penalties or interest charges, if they come into voluntary compliance. The ACT members will follow-up with the current FSLG Director, Mr. Paul Marmolejo, to offer assistance with any changes that may be needed to the existing closing agreements used by FSLG.

V. GOALS AND RECOMMENDATIONS

The ACT recommends the following actions:

1. During the second phase of the project (July 2009 to June 2010), the work products (for example, recommended revisions to the checklist, text for the Internet Toolkit to explain the purpose of the checklist, and instructions for the users as to how to use it and self-correct any problems they identify) will be “pilot tested” and vetted by the ACT with public employers and their stakeholder organizations before ACT members finalize them during 2009-2010. The work products will also be “vetted” with public employers’ stakeholder organizations, such as the GFOA and the NCSSSA.

The ACT members will also ask the FSLG Director to share the results of the focus groups and pilot testing process and the revised products that result with other appropriate TE/GE and other IRS officials to verify content and appropriateness of including and sharing content with the general public. ACT members will also work with experts within SSA who review and approve the Social Security and Medicare benefits and coverage of public employees, to ensure those portions of the checklist are accurate and complete. Improvements, enhancements, and other changes that are recommended during the testing and vetting process will be incorporated into the final form. The vetting process will also facilitate “buy-in” to the product by stakeholders, thus encouraging its future use.

2. Once finalized, as part of the 2010 ACT report, it is recommended that it be formatted by the IRS Forms and Publications, or other appropriate division within the IRS, for on-line use by public employers and their legal and financial advisors.

The IRS should make it as easy as possible for public employers to use the self-check guide. Thus, the ACT recommends that the IRS make the checklist into an on-line form that can be saved and returned to by public employers without losing information they have already entered. It should also be printable. This approach will serve all types and sizes of employers. For example, many small public employers only have part-time staff who do their accounting and employment tax reporting. Depending on the person’s level of knowledge and experience with the maze of laws that apply to public employers’ tax compliance, they may need to contact their counterparts in other similar organizations or other officials within the government to ensure they accurately and completely prepare the “self-check” form.

Also, most mid- to large-sized public employers have a division of responsibilities. Thus, the person completing the form may not have all

information needed to answer all of the questions contained in the form; for example, the Payroll Office may need to go to the Accounts Payable Office for information about how 1099's are processed.

It is also recommended that the form include easy-to-use features. At a minimum, to maximize ease of use, the form should:

- A. Include, where appropriate, "drop-down" boxes, with alternative possible answers to the questions that are asked.
- B. Allow public employers to copy and insert information into the form on-line and print a final version.
- C. Permit employers to "save" their work, in case they are unable to complete the form in one sitting.
- D. Radial buttons (for the "Yes", "No", "Not Applicable, N/A" options for each question, to prevent multiple selections as answers).
- E. Drop-down boxes with logical options and a "fill-in-the-blank" option where an additional entry can be typed, to address the likelihood that the available options will not be all-inclusive.
- F. The ability to transmit the completed form electronically to an FSLG Specialist for review and follow-up; and other, similar, user-friendly, on-line techniques.

These features, the content of the form, and how the form is organized will be part of the "pilot testing" period during 2009-2010 that the FSLG Subcommittee envisions having employers and other stakeholders help test and evaluate.

- 3. The ACT also recommends that, after the on-line form is finalized and approved, that the IRS widely publicize the checklist. The publicity should include stakeholder organizations for public employers, to maximize the distribution of the form's availability as a compliance tool.
- 4. The ACT members recommend that they work with the FSLG Director to determine what and how the voluntary closing agreement process for correction of items indicated in the checklist should be handled, after the on-line form is finalized and approved.
- 5. The name and link to *the Quick Reference Guide for Public Employers* (http://www.irs.gov/pub/irs-tege/public_employers_outreach_guide.pdf) should be added to the FSLG Toolkit, as part of the list of publications that are available under the subsection entitled "Public Employer's Toolkit." That *Guide* is included as one of the principal resources that should be available to public

employers who complete the self-check form on-line. The *Guide* is included on the website under “educational materials,” but our goal should be to make it as easy as possible for employers to find everything they need with as little effort as possible. By having the key references and links in the Public Employer’s Toolkit, efforts by federal and state officials to direct employers to the site will be more effective. The fewer “mouse-clicks” required by a user on the web, the better. **This recommendation can be implemented immediately.**

6. Include a note and link to the guide entitled *Retirement Plans for Government Employers* (Appendix C) in the FSLG Public Employer’s Toolkit after it is added to the “Retirement Toolkit” by the IRS. A similar note and link to the document should be added to the Employee Plans website. **This recommendation can be implemented immediately**

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VI. APPENDICES

See the separately identified Appendices A, B, and C, as follows:

- **Appendix A: Federal State And Local Governments Form 4318 Compliance Check**
- **Appendix B: Draft Compliance Verification Checklist for Federal, State, and Local Governmental Entities**
- **Appendix C: Retirement Plans for Government Employers**

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Appendix A

Federal State and Local Governments Form 4318 Compliance Check

Taxpayer's TIN:		Compliance Check Form Numbers:	
Taxpayer's Name:		Tax Return Year(s):	
Address – Line 1		XXXXXXXXXXXXXXXXXX	XXXXXXXXXX
Address – Line 2		FSLG Specialist:	
Town, State, ZIP		Grade:	Select
Entity Contact Person and Title:		Time on Case:	
Entity Phone Number:		Entity Fax Number:	
Representative Name:		XXXXXXXXXXXXXXXXXX	XXXXXXXXXX
Representative Phone Number:		Representative Fax Number:	
Reviewer:		Date Reviewed:	

Delinquent Return Reminders:	Yes/No/NA
Delinquent Returns Secured/Processed if Necessary	<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> N/A
Any Tax Due?	<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> N/A
Solicit Payment?	<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> N/A
Installment Agreement?	<input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> N/A

Section	Description	W/P Ref:
1.	Administrative	A
2.	Pre-Contact Analysis/Research	B
3.	218 Coverage or QAP	C

Index	4318 Continued																									
A.	Administrative: Activity Record Case Selection Survey Correspondence Summary: L3575 – Compliance Check Appointment Letter L3576 – Compliance Check Closing Letter <table border="1"> <tr> <td>Comments:</td><td></td></tr> </table>	Comments:																								
Comments:																										
B.	Pre-Contact Analysis/Research: Overview Summary: Forms 941 – W-3 – W-2 Reconciliation <table border="1"> <tr> <td>Comments:</td><td></td></tr> </table> IDRS Summary: <table border="1"> <tr> <td>Comments:</td><td></td></tr> </table> Other Summary (Articles, Internet, Etc.) <table border="1"> <tr> <td>Comments:</td><td></td></tr> </table>	Comments:		Comments:		Comments:																				
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C.	218 Coverage or QAP Summary: A. Does Taxpayer Have A 218 Agreement? <input type="checkbox"/> Yes <input type="checkbox"/> No B. Does Taxpayer Have A Copy Of Its 218 Agreement? <input type="checkbox"/> Yes <input type="checkbox"/> No C. Modifications: <table border="1"> <thead> <tr> <th>Number</th><th>Date</th><th>Description</th></tr> </thead> <tbody> <tr><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td></tr> </tbody> </table> D. Excluded Categories Of Workers: <table border="1"> <thead> <tr> <th>Category of Worker</th><th>Exclusion Date</th></tr> </thead> <tbody> <tr><td> </td><td> </td></tr> <tr><td> </td><td> </td></tr> <tr><td> </td><td> </td></tr> </tbody> </table> <table border="1"> <tr> <td>Comments:</td><td></td></tr> </table>	Number	Date	Description													Category of Worker	Exclusion Date							Comments:	
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Category of Worker	Exclusion Date																									
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SECTION II – INITIAL INTERVIEW INFORMATION**A. Location Of Meeting:**

--

B. Present At Meeting:

Name	Title	Phone Number

C. Does Taxpayer Have More Than One EIN? ☐ Yes ☐ No
If Yes, Provide Legal Names And Assigned EIN:

Legal Name	Assigned EIN

D. Have You Provided and Discussed the Following?

Item	Description	Yes/No
Notice 609	Privacy Act	<input type="checkbox"/> Yes <input type="checkbox"/> No
Pub 1	Your Rights As Taxpayers	<input type="checkbox"/> Yes <input type="checkbox"/> No
Pub 3114	Compliance Check, Examination, Or Review	<input type="checkbox"/> Yes <input type="checkbox"/> No
Pub 3809	Federal, State, & Local Governments	<input type="checkbox"/> Yes <input type="checkbox"/> No

E. Did You Discuss Compliance Check Vs Examination With Taxpayer Or Representative? ☐ Yes ☐ No

F. Describe the Form of Government – Explain who and how decisions are made regarding such items as personnel selections, treatments, provision of benefits, etc.

Comments:	
------------------	--

G. Specialist Should Discuss The Taxpayer's Payment Process And Safeguards State And Local Governments Need To Employ In Order To Maintain Proper Internal Controls.

Comments:	
------------------	--

SECTION III – FRINGE BENEFITS

In this section, the Specialist should discuss with the taxpayer various types of cash or non-cash benefits that are taxable fringe benefits and provide the taxpayer an opportunity to ask questions and receive information. The Specialist should focus on discussing fringe benefits that are common to the specific type of entity. For example, a police department may have issues with regard to cars, uniforms, etc.

1. Is Taxpayer Aware That All Benefits (Cash or Non-Cash) Are:

A.	Taxable Unless Exempt By Law?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
B.	Reported On Form W-2?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
C.	Subject To All Applicable Federal Employment Taxes?	<input type="checkbox"/> Yes	<input type="checkbox"/> No

Educate Taxpayer On The Issue And Provide Appropriate Publications.

Comments:	
------------------	--

SECTION IV – EMPLOYEE OR INDEPENDENT CONTRACTOR

In this section, the Specialist should discuss with the taxpayer the statutory and common law rules applicable to employees and independent contractors and provide the taxpayer an opportunity to ask questions and receive information.

1. In Determining If A Worker Is An Employee or An Independent Contractor, Does The Taxpayer Refer To:

A.	IRC Section 3121(d)?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
B.	Categories Of Evidence?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
C.	Common Law Factors (Rev Rul 87-41)?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
D.	Publication 15-A?	<input type="checkbox"/> Yes	<input type="checkbox"/> No

Educate Taxpayer Regarding The Ramifications Of Incorrect Classification Of Workers.

Comments:	
------------------	--

If, as a result of research conducted, the Specialist knows that the taxpayer has provided Forms W-2 and 1099 to the same individual the Specialist should discuss this with the taxpayer and offer the taxpayer the opportunity and FSLG's assistance to correct its filings, if necessary.

2. Is Taxpayer Aware Of The Limited Circumstances When It Is Appropriate For An Employee To Receive Both A Form W-2 and Form 1099-Misc In The Same Year?

☐ Yes ☐ No

Educate the taxpayer on situations where an employee provides services as an employee and should receive a Form W-2 and where substantially different services are provided as an independent contractor and should receive a Form 1099. Provide taxpayer with appropriate written publications.

COMMENTS:

SECTION V – FORM 1099-MISC

In this section, the Specialist should discuss with the taxpayer the various situations under which a Form 1099 must be filed. After the discussion, if the taxpayer indicates they might have a problem, the Specialist should offer the taxpayers assistance in filing or correcting any Form 1099.

1. Is Taxpayer Aware Of The General Criteria For Filing Forms 1099-Misc?

A.	Payments Of \$600 or More?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
B.	Payments For Services or Combination Of Products and Services?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
C.	Payments To Individuals, Partnerships, and Certain Corporations?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
D.	Payments To Attorneys, Even If Incorporated?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
E.	Certain Medical and Health Care Payments, Even If Incorporated?	<input type="checkbox"/> Yes	<input type="checkbox"/> No

Educate the taxpayer on filing requirements and provide appropriate written publications. Offering FSLG's assistance to the taxpayer in filing any Form 1099 would be appropriate at this time.

COMMENTS:

SECTION VI – FORM W-9

In this section, the Specialist should discuss with the taxpayer the requirements for obtaining correct TINs from vendors and requirements of backup withholding and provide the taxpayer an opportunity to ask questions regarding its particular situation.

1. Is The Taxpayer Aware Of The Benefits Of Securing Form W-9, or Its Equivalent, For Every Vendor?

A.	To Assist In Filing Forms 1099-Misc	<input type="checkbox"/> Yes	<input type="checkbox"/> No
B.	Protection From Backup Withholding Liability?	<input type="checkbox"/> Yes	<input type="checkbox"/> No

Educate taxpayer on benefits of securing Form W-9 and provide written publications for guidance.

COMMENTS:

SECTION VII – BACKUP WITHHOLDING (CP 2100 NOTICES)

In this section, the Specialist should review with the taxpayer CP 2100 procedures and when backup must be implemented and when it can be stopped.

1. Has The Taxpayer Received, In The Last Three Years, Notification CP 2100 or “B” Notices, or Letter 972-CG?

☐ Yes ☐ No

2. Did The Taxpayer Know What To Do When They Received:

A.	The First Notice On A Vendor?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
B.	The Second Notice On A Vendor?	<input type="checkbox"/> Yes	<input type="checkbox"/> No

3. Does The Taxpayer:

A.	Compare Current Notices To Prior Notices?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
B.	Know What Action To Take If The Vendor Will Not Give An EIN Or Gives An Obvious Incorrect Number?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
C.	Know The 2 of 3 Year Requirement To Begin Backup Withholding?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
D.	Know When To Implement Backup Withholding?	<input type="checkbox"/> Yes	<input type="checkbox"/> No

Comments:

4. Has The Taxpayer Ever Implemented Backup Withholding?☐ Yes ☐ No If Yes, Describe The Circumstances:Comments:

5. Has The Taxpayer Ever Filed Form 945? ☐ Yes ☐ No

If Yes, For What Years:

Year:	Year:	Year:	Year:	Year:
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SECTION VII – RETIREMENT SYSTEM COVERAGE**1. Does The Taxpayer Offer The Following Retirement Plans?**

Type of Plan	Offered		Tax Deferred	
Defined Benefit (Rev. Proc. 91-40 & IRC 414(j))	<input type="checkbox"/> Yes	<input type="checkbox"/> No	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Defined Contribution (i.e. IRC 401(a), 403(b), 457)	<input type="checkbox"/> Yes	<input type="checkbox"/> No	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Deferred Compensation (IRC 457(b))	<input type="checkbox"/> Yes	<input type="checkbox"/> No	<input type="checkbox"/> Yes	<input type="checkbox"/> No
SEP IRA	<input type="checkbox"/> Yes	<input type="checkbox"/> No	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Other (Describe):	<input type="checkbox"/> Yes	<input type="checkbox"/> No	<input type="checkbox"/> Yes	<input type="checkbox"/> No

2. Are ALL Employees Covered Under A Retirement System? ☐ Yes ☐ No

If No, What Categories Of Employees Are Not Covered?

A.	
B.	
C.	
D.	

3. Have You Received A Determination Letter (IRC 401(a))? ☐ Yes ☐ No**4. Is The Pension Plan Offered To All Employees? (Universal Availability) ☐ Yes ☐ No**

5. Is Everyone Offered The Right To Make Elective Deferrals? ☐ Yes ☐
No

Appendix B

Compliance Verification Checklist for Federal, State, and Local Governmental Entities

Purpose

This Compliance Verification Checklist (also referred to as “checklist” or “self-check”) is designed to allow federal, state and local government organizations (also referred to in this form as “public employers”) to conduct a self-assessment of their level of compliance with federal tax laws, rules, and regulations. At the beginning of each section, there is a brief description of the basic legal requirements that apply to public employers for that category of requirements. Where necessary, due to the many nuances in the law that apply to some compliance subcategories, additional explanation of the requirements and resources are provided.

Public employers have unique legal requirements for compliance with the federal tax code (U.S. Internal Revenue Code, IRC) and federal Social Security and Medicare coverage (U.S. Social Security Act). Public employers must be aware of numerous differences from the private sector that apply to them and their workers (both employees and independent contractors), especially related to employment tax, FICA, Social Security (Old-Age, Survivor, Disability Insurance) coverage, Medicare (Health Insurance) coverage, and public pension system obligations.

Common Errors

During past **Compliance Checks and Examinations** of public employers that FSLG has conducted, a number of common errors have been identified:ⁱ

- Amounts on Forms W-2, W-3, and 941 do not reconcile.
- Forms W-9 and W-4 are not being used or are not being updated when necessary.
- Public employers are unaware of the requirement to backup withhold if no Taxpayer Identification Number (TIN) is provided by a vendor prior to payment.
- Form 1099 problems:
 - The forms were not prepared at all.
 - The forms were prepared incorrectly, such as the amounts are in the wrong box, etc.
 - The forms were prepared, but not submitted to the IRS.
- Employment tax return filing and deposit problems:
 - Deposits were made, but no return was filed.
 - Deposits were made to an incorrect period.
- Unaware of electronic filing requirement and unaware of FIRE system (Filing Information Returns Electronically).
- Elected officials are treated as independent contractors, rather than as employees.
- Failure to pay and withhold Medicare-only tax on rehired annuitants.
- Election officials and workers treated as independent contractors, rather than as employees.

Due to the complexity of the law, however, other errors can occur, especially for smaller public employers. This Compliance Verification Checklist is designed to help public employers identify their issues and concerns and work with FSLG, SSA, and their State Social Security Administrator (depending on the issue) to correct the mistakes, so they become fully compliant with applicable federal laws and regulations.

For Assistance While Completing the Form

General resources that cover all aspects of this Compliance Verification Checklist can be accessed at the following websites:

- *Federal-State Reference Guide (Publication 963)*, <http://www.irs.gov/pub/irs-pdf/p963.pdf>
- *Quick Reference Guide for Public Employers*, http://www.irs.gov/pub/irs-tege/public_employers_outreach_guide.pdf
- *IRS Federal, State and Local Governments Public Employer Tax Guide*: http://www.irs.gov/pub/irs-tege/public_employers_outreach_guide.pdf
- *Independent Contractor or Employee Brochure*, <http://www.irs.gov/pub/irs-pdf/p1779.pdf>
- FSLG website, which can be accessed at: <http://www.irs.gov/govts>.
- Federal-State-Local Government (FSLG) Toolkit, <http://www.irs.gov/govt/fslg/article/0,,id=158481,00.html>
- *Retirement Plans for Government Employers*, [insert link after this document is posted on the Retirement Toolkit website]
- *Governmental Plans Information (IRS Employee Plans)*, <http://www.irs.gov/retirement/article/0,,id=181779,00.html>
- *Correction Governmental Plan Errors*, <http://www.irs.gov/retirement/article/0,,id=96907,00.html>
- U.S. Social Security Administration Information for Federal, State, and Local Government Employees Regarding Social Security Benefits Reductions, <http://www.ssa.gov/gpo-wep/>
- *Employer's Supplemental Tax Guide (Publication 15)*, <http://www.irs.gov/pub/irs-pdf/p15a.pdf>
- *Employer's Guide to Fringe Benefits (Publication 15)*, <http://www.irs.gov/pub/irs-pdf/p15b.pdf>
- *Taxable Fringe Benefit Guide*, http://www.irs.gov/pub/irs-tege/fringe_benefit_fslg.pdf
- IRS educational products for government employers: <http://www.irs.gov/govt/fslg/content/0,,id=117706,00.html>
- General Social Security Administration (SSA) information is available on SSA's homepage (www.ssa.gov) and more specific information pertinent to government employers and employees is available at: www.ssa.gov/slge.

Where to Go For Assistance and Further Information after Completing the Form

After completing the Compliance Verification Checklist, you are encouraged to contact your Federal-State-Local Government (FSLG) agent at the Internal Revenue Service (IRS). The FSLG Specialist can help you interpret the results of the self-check and ensure that you know what, if any, steps you need to take to be fully compliant with all applicable federal tax laws, rules, and regulations. The primary objective of FSLG is to ensure compliance with federal employment tax laws by governmental entities through the use of review and examination activities as well as through educational programs. The names and contact information for FSLG staff are available at: <http://www.irs.gov/govt/fslg/article/0,,id=96060,00.html>.

The FSLG Specialist may recommend that you contact your State Social Security Administrator for clarifications and information about a Section 218 Agreement, how to obtain Medicare-only coverage for Medicare-exempt employees, or other similar information about which the State Administrator has responsibility and knowledge. Each state's laws are unique in how they enacted the voluntary Social Security (and, later, Medicare) coverage agreements for state and local government employees. To learn more, you should contact the State Social Security Administrator for your state by going to: <http://www.ncsssa.org/statessadminmenu.html>.

The FSLG Specialist may also suggest that you contact the U.S. Social Security Administration (SSA) for further information about coverage and benefits under Social Security and Medicare, how an employee's or employee's spouse's Social Security benefits may be reduced (i.e., offset) by a public pension payment, and other issues that are unique to Social Security and Medicare benefits that are paid to government employees. FSLG works with the SSA to educate government entities about Section 218 Social Security Agreements. These voluntary agreements provide Social Security and/or Medicare coverage for state and local employees. While IRS is responsible for administering and enforcing the tax laws, SSA processes and interprets these agreements and related coverage issues. General SSA information is available at the Social Security Administration homepage (www.ssa.gov) and more specific information pertinent to government employers and employees is available at: www.ssa.gov/slge.

Entity Identification and Contact Information			
Entity (Taxpayer's) Name			
Entity's Level and Type of Government (check only one box, then select the type of government from the appropriate drop-down box)	Federal	State	Local
	<i>Insert drop-down boxes for each of the above choices with options (e.g., Federal Department, State, county, municipality, etc.)</i>		
Entity (Taxpayer's) TIN (Tax Identification Number)			
List any other TIN's associated with the entity, including name that is listed for the TIN	<i>Alpha-numeric fields, below, should allow for multiple entries</i>		
	Legal Name		Assigned TIN or EIN
Office Location (Address – Line 1)		<i>Alpha-numeric field</i>	
Office Location (Address – Line 2)		<i>Alpha-numeric field</i>	
City, State, ZIP Code		<i>Insert drop-down box with options</i>	
Name of Person Completing Questionnaire			
Title of Person Completing Questionnaire			
Telephone Number of Person Completing Questionnaire			
Fax Number of Person Completing Questionnaire			
Email of Person Completing Questionnaire			
Entity Contact Name (if different from Name of Person Completing Questionnaire)			
Title of Contact Name (if different from Name of Person Completing Questionnaire)			
Telephone Number of Contact Name (if different from Name of Person Completing Questionnaire)			
Fax Number of Contact Name (if different from Name of Person Completing Questionnaire)			
Email of Contact Name (if different from Name of Person Completing Questionnaire)			

Compliance Categories:

- Worker Classification: Employee versus Independent Contractor.
- Social Security Coverage (Section 218 Agreement and Mandatory Social Security Coverage).
- Medicare Qualified Government Employees (MQGE) and Medicare Exempt Employees.
- Retirement Plan Coverage as a Substitute for Social Security Coverage.
- Fringe Benefits.
- Other Tax Issues: Information Reporting, Vendor Payments, Back-up Withholding, and Timely Filing of Returns.
- Social Security Benefits Offsets for Public Employees.

Draft

Worker Classification: Employee versus Independent Contractor

In general, an **employee** is anyone who performs services subject to the will and control of the individual or entity paying for the services. Payments to employees in the form of cash, property, services or other benefits are taxable wages, unless excluded by a specific provision of the law. Taxable wages are reported on Form W-2, Wage and Tax Statement. W-2 and W-3 filing information is available on SSA's website at: <http://www.socialsecurity.gov/employer/>.

For a full discussion of how to determine who is an employee, see Publication 963 and Publication 15-A.

Independent contractors include any person or business that performs services for you and is not subject to your will and control as an employee. Generally, any payment of \$600 or more during a calendar year is reportable on Form 1099-MISC, Miscellaneous Income, by January 31 of the following year. For more information on information reporting, see the Instructions for Form 1099-MISC.

Note: Beginning in 2011, certain payments by governmental entities to independent contractors are subject to 3% withholding. For more information, see www.irs.gov/govt.

Yes	No	N/A	
			<p>1. For those entities without a Section 218 Agreement or for classes of workers who are not covered by a Section 218 Agreement, have you reviewed the facts and circumstances and made a determination under the common-law criteria that all workers are properly classified and treated accordingly?</p> <p>Note: There are three categories of factors (Behavioral, Financial and Relationship of the parties) that should be considered to determine whether the worker is an employee or independent contractor. Tax and penalties may apply if you misclassify a worker. See IRS Publication 1779, Independent Contractor or Employee, http://www.irs.gov/pub/irs-pdf/p1779.pdf and IRS Publication 963, Chapter 4, for information about worker classification.</p>
			<p>2. Do you have any workers for which you are uncertain as to the proper classification -- independent contractor versus employee?</p> <p>Note: You can submit an SS-8 form (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding) to the IRS to obtain a determination about whether or not a particular worker is an independent contractor or employee of the governmental entity?</p> <p>Note: Form SS-8 is available at: http://www.irs.gov/pub/irs-pdf/fss8.pdf.</p>

Social Security Coverage (Section 218 Agreement and Mandatory Social Security Coverage)

Public employers need to be aware of the rules that govern Social Security and Medicare (FICA) coverage for their employees. Public employees may be subject to Social Security tax, either through mandatory withholding, or through the provisions of a Section 218 Agreement. They may be exempt from Social Security if they are covered by a qualifying public retirement system (see the compliance category section of this checklist entitled "Retirement Plan Coverage as a Substitute for Social Security Coverage" for details). Several legal issues must be considered to determine the correct Social Security and Medicare status of a worker.

If the position is covered, either by an Agreement or under mandatory coverage, your worker is subject to Social Security up to the wage base (SSA adjusts the wage base annually; for the current base, go to: <http://www.socialsecurity.gov/OACT/COLA/cbb.html>) and Medicare tax. There is no wage base limit for Medicare tax. The employer pays matching amounts of these taxes.

*A Section 218 Agreement is made between the Social Security Administration and a state's Social Security Administrator to provide coverage for a group of state or local government employees. **A Section 218 Agreement covers positions, not individuals.** Since April 20, 1983, any public employer who had previously entered into a Section 218 Agreement to cover their employees must continue to cover employees under the Agreement, regardless of whether or not another qualifying public retirement plan is made available. Coverage under a Section 218 Agreement supersedes all other considerations.*

If a public employer wants to provide both a qualifying FICA replacement plan and full Social Security coverage for its employees, a referendum election must be conducted by the State Social Security Administrator (or by the Social Security Administration, if the entity is an interstate instrumentality). An Interstate Instrumentality is an independent legal entity organized by two or more states to carry out one or more governmental functions. For purposes of a Section 218 Agreement, an interstate instrumentality has the status of a state. See Publication 963, Chapter 5, for details about the referendum process.

The referendum process can also be used to obtain Medicare-only coverage for Medicare exempt government employees (anyone hired prior to April 1, 1986, who has been in continuous employment with the same employer since that time). See the compliance category section of this checklist entitled "Medicare Coverage and Medicare Exempt Government Employment" and Chapter 5 in Publication 963 for further information.

Mandatory Social Security coverage ceases for a state or local government employee when he or she becomes a member of a qualifying public retirement system.

In addition to the reference materials noted earlier in this checklist, the FSLG website includes information entitled, "What State or Local Government Employers Should Know About Social Security and Medicare Coverage", which can assist employers in determining their Social Security and/or Medicare coverage and FICA requirements. That site is available at: <http://www.irs.gov/govt/fslg/article/0,,id=182888,00.html>.

Social Security Coverage (Section 218 Agreement and Mandatory Social Security Coverage)			
Yes	No	N/A	
			1. Does the entity have a voluntary Social Security (full Social Security and Medicare) coverage agreement, often referred to as a Section 218 Agreement?
			2. Are services performed by any of your employees mandatorily excluded from Social Security and Medicare (FICA) coverage? Note: Federal law requires the exclusion of the following services from voluntary (Section 218) coverage under the Social Security Act (Section 218(c)(6)): <ul style="list-style-type: none"> • Services performed by individuals hired to be relieved from unemployment. • Services performed in a hospital, home or other institution by a patient or inmate thereof as an employee of a state or local government. • Services performed by an employee hired on a temporary basis in case of fire, storm, snow, earthquake, flood or similar emergency. • Services performed by a nonresident alien temporarily residing in the U.S. holding an F-1, J-1, M-1 or Q-1 visa, when the services are performed to carry out the purpose for which the alien was admitted to the U.S. • Services in positions compensated solely by fees that are subject to SECA (Self-Employment Contributions Act), unless a Section 218 Agreement covers these services. • Services performed by a student enrolled and regularly attending classes at the school, college or university where they are working, unless a Section 218 Agreement covers student services. • Services performed by election officials or election workers paid less than the calendar year threshold amount mandated by law, unless a Section 218 Agreement covers election workers. • Services that would be excluded if performed for a private employer because it is not work defined as employment under Section 210(a) of the Social Security Act, unless a Section 218 Agreement covers certain agricultural services. <p>See Chapter 5 of Publication 963, for details on what constitutes a mandatory exclusion under federal law.</p>
			3. If the entity does have a Section 218 Agreement, what classes of employees are included (or excluded) from the Agreement? <i>Alpha-numeric field should allow for multiple entries</i>
Yes	No	N/A	
			4. If the entity has a Section 218 Agreement, have any

Social Security Coverage (Section 218 Agreement and Mandatory Social Security Coverage)			
			Modifications to the Agreement been adopted?
			A. If “yes”, list all Modification numbers, dates, and a description of what changes to the Section 218 Agreement were made by each Modification. <i>Alpha-numeric field should allow for multiple entries</i>
			5. Does the entity pay full FICA -- Social Security (Old-Age, Survivor, Disability Insurance) and Medicare (Health) Insurance – on all employees?
			A. If “yes”, is the entity paying full FICA based on a voluntary Section 218 Agreement? (See Chapter 5 of Publication 963 for details).
			6. If the entity has no Section 218 Agreement, does the entity pay full FICA based on mandatory Social Security provisions contained in Omnibus Budget Reconciliation Act (OBRA) 1990 (see Chapter 6 of Publication 963 for details).
			7. Does the entity have any of the following categories of workers?
			A. Elected officials. Note: A public official has authority to exercise the power of the government and does so as an agent and employee of the government. For this reason, the Supreme Court has held that public officials are employees. A public official performs a governmental duty exercised pursuant to a public law. A public office is a position created by law, holding a delegation of a portion of the sovereign powers of government to be exercised for the benefit of the public. <i>Metcalf & Eddy v. Mitchell</i> , 269 U.S. 514 (1926). For the same reason, elected officials are subject to a degree of control that typically makes them employees under the common law. Elected officials are responsible to the public, which has the power not to reelect them. Elected officials may also be subject to recall by the public or a superior official. In any event, elected officials are employees for income tax withholding purposes under Internal Revenue Code section 3401(c).
Yes	No	N/A	
			B. Appointed officials. Note: Very few appointed officials have sufficient independence such that they will not be considered common-law employees.

Social Security Coverage (Section 218 Agreement and Mandatory Social Security Coverage)

			<p>C. Part-time positions.</p> <p>Note: After July 1, 1991, full-time, part-time, temporary and seasonal employees who are not participating in a qualifying retirement system made available through their employer MUST be covered by Social Security and Medicare. It is also possible for employees under a public retirement system to be covered for Social Security if a Section 218 Agreement covers them.</p>
			<p>D. Fee-based positions.</p> <p>NOTE: In general, if an individual performs services as an official of a governmental entity and the remuneration received is paid from governmental funds, the official is an employee and the wages are subject to Federal employment taxes. Examples of public officials include, but are not limited to, the President, a governor, mayor, county commissioner, judge, justice of the peace, sheriff, constable, registrar of deeds, building and plumbing inspectors, etc.</p> <p>An exception to this rule applies to a fee-based public official. A fee-based public official receives his/her remuneration in the form of fees directly from the public with whom he/she does business. However, if the fee service is covered by a Section 218 agreement, the services is covered as Employment, as discussed in Publication 15, <i>Employer's Tax Guide</i> (Circular E).</p>
			<p>E. Does the entity have volunteer firefighters?</p> <p>Note: Volunteer firefighters are considered employees and their remuneration is generally subject to all withholding taxes. However, if the payment is reimbursement for out-of-pocket expenses actually incurred in the course of work, and the payment is accounted for according to the requirements of IRS Regulations regarding accountable plans, then the payment could be excludable from the rest of the firefighter's Form W-2. (See the section of the checklist entitled, "Fringe Benefits" for information about "accountable plans.") See Publication 963 for more information on this issue. See the <i>IRS Quick Reference Guide for Public Employers</i>, for more information.</p>
Yes	No	N/A	
			<p>8. Does the entity have any of the following categories of workers?</p>
			<p>A. Agricultural labor (if their services would be excluded if performed for a private sector employer).</p> <p>Note: Agricultural labor may continue to be excluded from Social Security and Medicare coverage even if they are not under a public retirement system. However, these services may be covered by a</p>

Social Security Coverage (Section 218 Agreement and Mandatory Social Security Coverage)

			218 Agreement and, therefore, subject to FICA.
			<p>B. Student services (if their services would be excluded if performed for a private sector employer).</p> <p>Note: Students who are enrolled and regularly attending classes at the school where they are working are exempt from paying Social Security and Medicare taxes. However, these services may be covered by a 218 Agreement and, therefore, subject to FICA.</p> <p>Medical residents are generally common-law employees of the hospitals for which they work, and therefore are subject to Social Security and Medicare taxes (unless they are excepted by a Section 218 Agreement). However, IRC 3121(b)(10) provides an exception for students employed by a school, college, or university (SCU) who are enrolled and regularly attending classes at the SCU.</p> <p>In order for medical residents to meet this exception, several conditions must be met. For details, see Regulation 31.3121(b)(10)-2 and Revenue Procedure 2005-11: http://www.irs.gov/irb/2005-02_IRB/ar16.html.</p>
			<p>C. Services performed by election officials or election workers if they are paid less than the current dollar threshold. For the current threshold amount, go to: IRS Publication 963, Chapters 5 and 10.</p> <p>Note: If an election worker earns \$1,500 or more in a calendar year (effective January 1, 2009), all the worker's earnings, including the first \$1,500 are subject to the FICA taxes. If it is anticipated that an election worker may earn \$1,500 or more in a calendar year, a government employer may choose to begin withholding FICA taxes on the first dollar earned. If the worker then earns less than \$1,500 in the calendar year, the worker would be entitled to a refund of the erroneously withheld FICA taxes. If the employer chooses not to begin withholding until after the worker earns \$1,500, the employer would be liable for the total amount of FICA taxes due. The employer could recover the employee's share of the FICA from the employee by withholding from future earnings or by other arrangements with the employee.</p>

Medicare Qualified Government Employees (MQGE) and Medicare Exempt Employees

If a state or local government employee was hired after March 31, 1986, it is mandatory that both the worker and public employer pay Medicare tax. See Revenue Ruling 86-88 in the Appendix to Publication 963.

If the worker was hired prior to April 1, 1986, the employee is exempt from Medicare if he or she was a bona fide employee on that date and has been in continuous service since that time. Medicare coverage depends on whether the worker is currently covered by a pension plan that meets Internal Revenue Service requirements. See the compliance category section of this checklist entitled

Medicare Qualified Government Employees (MQGE) and Medicare Exempt Employees

"Retirement Plan Coverage as a Substitute for Social Security Coverage" and Chapter 5 of Publication 963 for details.

The referendum process can also be used to obtain Medicare-only coverage for Medicare exempt government employees (anyone hired prior to April 1, 1986, who has been in continuous employment with the same employer since that time). See the compliance category section of this checklist entitled "Social Security Coverage (Section 218 Agreement and Mandatory Social Security Coverage)" and Chapter 5 in Publication 963 for further information.

*All state and local government employees who are covered by a Section 218 Agreement must pay both Social Security **and** Medicare.*

Yes	No	N/A	
			1. Does the entity have any employees for whom you ONLY PAY Medicare?
			A. If "yes", are those employees also covered by a qualifying public pension plan (i.e., a substitute for FICA coverage, based on OBRA 1990)? See the compliance category section of this checklist entitled "Retirement Plan Coverage as a Substitute for Social Security Coverage" and Chapter 5, Publication 963, for details.
			B. If "yes", are any of those employees covered by a Medicare-only Section 218 Agreement, because they were hired on or before April 1, 1986?
			2. Does the entity have any employees for whom it DOES NOT PAY Medicare?
			A. If "yes", were those employees hired on or before April 1, 1986, and have been in continuous employment with the entity since that time?
			B. If "yes", please specify for which classification(s) of employees you DO NOT pay Medicare and how many employees are in each classification. See Chapter 1, Publication 963, for information about worker classification. Alpha-numeric field should allow for multiple entries
Yes	No	N/A	

Medicare Qualified Government Employees (MQGE) and Medicare Exempt Employees

			<p>3. Does the entity have any employees who have retired and started receiving an annuity payment from their public retirement system and were then hired back? If so, those employees are considered to be “rehired annuitants?”</p> <p>Note: A rehired annuitant is a retiree who is rehired by his or her employer or another employer that participates in the same retirement system as the former employer. A rehired annuitant is either drawing a retirement benefit from that retirement system, or has reached retirement age under the retirement system.</p>
			<p>A. If “yes” (the entity does have rehired annuitants), do you pay Social Security (the Old Age, Survivor, Disability portion) on those employees?</p> <p>Note: Rehired annuitants are excluded from mandatory Social Security coverage. However, if an employee is rehired to perform services in a state or local government position that is covered for Social Security under a Section 218 Agreement, services in that position are covered for Social Security. In addition, all retirees hired after March 31, 1986, are covered for Medicare.</p>
			<p>B. If “yes”, do you pay Medicare (the Health Insurance portion of Social Security) on those employees and also withhold the required 1.45% from the employees’ pay?</p>

Retirement Plan Coverage as a Substitute for Social Security Coverage

Effective July 2, 1991, Congress made Social Security coverage mandatory for state and local government employees who are neither covered by a Section 218 Agreement nor qualifying participants in a public retirement system. Under this provision, state or local governments can provide these mandatorily covered employees with membership in a public retirement system as an alternative to mandatory Social Security coverage. Employees may also be covered by both a public retirement system and Social Security under a Section 218 Agreement.

A governmental retirement plan must meet certain minimum benefit or contribution standards to qualify as a public retirement system, and thereby serve as a “replacement” plan exempting the participants from mandatory Social Security coverage.

For more information about public retirement systems (FICA replacement plans), go to the Retirement Plans for Government Employers, **[insert link after this document is posted on the Retirement Toolkit website]** and Chapter 6 of the Federal-State Reference Guide, Publication 963.

The IRS has introduced a governmental plan web page as part of an initiative to better serve its customers in the governmental plan community. This web page offers guidance, tools, educational materials, news, and other resources that the IRS hopes will be of particular interest and assistance to section 401(a), 403(b), and 457 governmental plans in maintaining compliance with the applicable federal tax-qualification requirements. Please check back frequently for updates to this page: <http://www.irs.gov/retirement/article/0,,id=181779,00.html>.

The Employee Plans Compliance Resolution System (EPCRS) offers a comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of sections 401(a), 403(a), 403(b), 408(k), or 408(p) of the Internal Revenue Code, but which have not met these requirements for a period of time. This system allows plan sponsors to correct these failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. The components of EPCRS are the Self-Correction Program (SCP), the Voluntary Correction Program (VCP), and the Audit Closing Agreement Program (Audit CAP). 457 Plans are not officially under this program yet, however the IRS will accept submissions under the VCP program on a provisional basis outside of EPCRS based on the same criteria.

For more information concerning this correction program, see [Correcting Plan Errors](http://www.irs.gov/retirement/article/0,,id=96907,00.html) at: <http://www.irs.gov/retirement/article/0,,id=96907,00.html>.

Retirement Plan Coverage as a Substitute for Social Security Coverage			
Yes	No	N/A	
			1. Does the entity have a public retirement system?
			<p>Note: A public retirement system is not required to be a qualified plan within the meaning of the Employees' Retirement Income Security Act of 1974 (ERISA). The employee may be a member of any type of retirement system, including a nonqualified system (for example, a section 457(b) plan, discussed below), as long as the plan provides a minimum level of benefits, as specified by law, under that system.</p> <p>A public retirement system may take one of two forms: the defined benefit retirement system, which is based on a guaranteed minimum benefit, and the defined contribution retirement system, which is based on a minimum contribution relative to salary.</p> <p>In order for a defined benefit retirement system to be a qualified plan, benefits must be measured by and based on various factors such as years of service rendered by the employee, compensation earned by the employee and the age of the employee at retirement. The Service issued Revenue Procedure 91-40 to clarify the minimum retirement benefit tests, which must be met in the plan's formula. This Revenue Procedure can be found in the Appendix of Publication 963, Federal-State Reference Guide.</p> <p>In order for a defined contribution retirement system to qualify, the worker must be covered in a plan in which at least 7.5% of his/her income is placed into a retirement plan. This contribution can be any combination of employer and employee contributions, but must total a minimum of 7.5% of his pay, and cannot include any credited interest in the calculation. The plan may include any plan described in section 401(a), an annuity plan or contract under section 403(b) or a plan described in section 457(b) or (f) of the Internal Revenue Code.</p> <p>Any person working for a public employer after July 1, 1991, who is <u>not covered in a pension plan that meets the requirements</u> discussed above or the defined benefit system safe harbor rules of Revenue Procedure 91-40, <u>must be covered by Social Security and Medicare under the mandatory coverage provisions</u> of Section 210 of the Social Security Act.</p>
Yes	No	N/A	
			2. Does the entity offer any of the following types of retirement plans? (Check all that apply)
			A. Defined Benefit [IRC 414(j) & Rev. Proc. 91-40].
			B. Defined Contribution [IRC 401(a), 403(b), 457]
			C. Deferred Compensation [IRC 457(b)]
			SEP IRA (Form 5305A-SEP, Salary Reduction Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement, under Internal Revenue Code Section 408(k)).

Retirement Plan Coverage as a Substitute for Social Security Coverage			
Yes	No	N/A	
			D. Other (describe): <i>Alpha-numeric field should allow for multiple entries</i>
			3. Is the retirement plan offered to all employees (i.e., universal availability)?
			4. Are all employees offered the right to make elective deferrals?
			5. Are ALL employees covered under a retirement system?
			A. If “no”, what categories of employees are NOT covered? (Specify all that apply) Note: Those not covered by a qualifying public retirement plan (i.e., retirement plan “ineligibles”) may be required to be covered by Social Security and Medicare under the mandatory Social Security provisions of OBRA 1990. See Publication 963, Chapters 5 and 13, for details. <i>Alpha field should allow for multiple entries</i>
			6. Has the entity received a Determination Letter [applies if the Plan is a qualified plan under IRC 401(a)] from the IRS?
			A. If “yes”, when was the latest Letter received? <i>Alpha field should allow for multiple entries</i>

Fringe Benefits

Fringe benefits include any compensation other than wages. Examples of taxable fringe benefits are:

- A. Personal use of an employer's cell phone, computer or vehicle.*
- B. Meals provided or reimbursed to an employee when they are not in overnight travel status.*
- C. Allowances for travel, vehicles or uniforms that do not meet the accountable plan rules.*

The following taxes apply to taxable fringe benefits: Social Security, Medicare and Income Tax Withholding.

Some fringe benefits are excluded from income based on provisions of the Internal Revenue Code. See the Taxable Fringe Benefit Guide on the IRS web site for more information: www.irs.gov/pub/irs-tege/fringe_bnft_flgsg.pdf. For a more detailed discussion of fringe benefits, see Publication 15-B, Employer's Tax Guide to Fringe Benefits.

Yes	No	N/A	
			1. Are you aware that all benefits (cash and non-cash) paid to employees are:
			A. Taxable unless exempt by law?
			B. Reported on Form W-2?
			C. Subject to all applicable Federal employment taxes, e.g., Federal income taxes, Social Security, and Medicare (FICA)? Note: Federal employment taxes also include the Federal Unemployment (FUTA) tax and self-employment tax, but public employers are not subject to those tax requirements. A description of all employment taxes is available at: http://www.irs.gov/businesses/small/article/0,,id=172179,00.html .
			2. Does the entity have an "accountable plan" for reimbursement of expenses incurred by employees? Note: In general, reimbursements or expenses paid by the employer on behalf of the employee are taxable unless they are for allowable excluded benefits or expenses, unless the reimbursements are made under an accountable plan. For payments to be considered to be made under an accountable plan, the employee must: (a) Incur the expenses in the performance of work; (b) Adequately account for the expenses within a reasonable period of time, and (c) Return any amounts in excess of expenses within a reasonable period of time. If the accountable plan rules are met, no tax reporting is necessary. If they are not met, the reimbursements or advances are included in wages, and the employee may deduct allowable business expenses on his or her Form 1040.

Fringe Benefits		
Yes	No	N/A
		<p>3. Does the entity allow the personal use of a government-owned vehicle?</p> <p>Note: Unless it is excludable because it is infrequent and of little value (a de minimis benefit), the personal use of a government-owned vehicle is a taxable fringe benefit. Personal use includes the value of commuting to and from work in a government-owned vehicle, even if the vehicle is taken home for the convenience of the employer. The value of the fringe benefit must be included in wages and is subject to income and employment taxes.</p> <p>All of your employee's use of a qualified nonpersonal use vehicle qualifies as a working condition fringe. You can exclude the value of that use from employee income. A qualified nonpersonal use vehicle is any vehicle the employee is not likely to use more than minimally for personal purposes because of its design. Examples include, but are not limited to:</p> <ul style="list-style-type: none"> ○ Clearly marked police and fire vehicles. ○ Unmarked vehicles used by law enforcement officers. The officer must be authorized to carry a firearm, execute search warrants and make arrests. ○ An ambulance or hearse used for its specific purpose.
		<p>4. Are taxable fringe benefits being reported as wages and taxes applied as required?</p> <p>Note: You must report these wages on Form W-2 and Form 941.</p>

Other Tax Issues: Information Reporting, Vendor Payments, Back-up Withholding, and Timely Filing of Returns

INFORMATION REPORTING

Compensation to employees and the required withholding are reported on Form W-2 and on Form 941. The requirements and procedures for employee reporting are discussed in detail in Publication 15, *Employer's Tax Guide* (<http://www.irs.gov/pub/irs-pdf/p15.pdf>).

A variety of information returns are required to report various other types of payments. Any entity, including a governmental organization, conducting a trade or business, is required to file information returns for certain payments. In most cases, these payments are reported on Form 1099-MISC, Miscellaneous Income.

The IRS Regulations state that every person engaged in a trade or business shall make an information return for each calendar year with respect to payments made by him to another person: salaries, wages, commissions for services rendered, interest, rents, royalties, annuities, pensions, and other gains, profits, and income **aggregating \$600 or more**. The returns used for this purpose are the forms in the 1099 series.

The return with respect to certain payments of compensation to an employee is made on Forms W-2 and W-3; **never use Form 1099-MISC to report payments for services by an employee.**

NOTE: Certain payments and recipients are exempt from the requirements, including:

- Payments to exempt organizations and governments
- Generally, payments to corporations BUT not attorneys' fees, medical and health care payments
- Payments of rent to real estate agents

See the *General Instructions for Forms 1099, 1098, 3921, 3922, 5498, and W-2G* (<http://www.irs.gov/pub/irs-pdf/i1099gi.pdf>) for details.

Form 1096, Annual Summary and Transmittal of U.S. Information Returns is used to transmit paper Forms 1099, 1098, 5498, and W-2G to the Internal Revenue Service. For details, see: http://www.irs.gov/pub/irs-pdf/f1096_08.pdf. Do not use Form 1096 to transmit electronically. For electronic submissions, see Publication 1220, Specifications for Filing Forms 1098, 1099, 5498, and W-2G Electronically (http://www.irs.gov/pub/irs-pdf/p1220_07.pdf).

Yes	No	N/A	
			1. Employment Tax Filings:
			A. Are all employment tax returns filed as required?
			B. Were all employment tax returns filed by the date required?
			C. Were all employment tax returns that were filed complete and accurate?
			D. Do Forms W-3, W-2, and 941 reconcile for the most recent calendar year?
			E. Were taxable fringe benefits included on Forms W-2 for the applicable employee?
			F. Are vehicles provided to employees?

Yes	No	N/A	
			G. Is lodging provided by the employer?
			H. Is tuition reimbursement provided by the employer?
			I. Was Tip Income, if any, properly recorded on Form 941?
			J. Does the entity provide for achievement awards of length of service awards?
			K. Does the entity provide Group Term Life Insurance?
			L. Does the entity provide for use of athletic or recreation facilities?
			M. Is any clothing provided by the employer?
			2. <u>Independent Contractor Reporting:</u>
			A. Does the entity make payments to vendors or independent contractors?
			B. Are forms W-9 on file for every vendor or independent contractor?
			C. Are all forms W-9 secured prior to initial payment? Note: You should obtain vendor information before any payments are made. Use Form W-9 (http://www.irs.gov/pub/irs-pdf/fw9.pdf), Request for Taxpayer Identification Number and Certification, or a substitute, to collect the owner's name (if sole proprietor), legal business name, mailing address, taxpayer identification number.
			D. Are all forms W-9 properly completed?
			E. Did the entity withhold federal income tax on miscellaneous income under the backup withholding rules?
			F. Are Forms 1099 filed for payments to all vendors and independent contractors for payments in excess of \$600 per year?
			G. Does the entity file Forms 1099s for payments for services or combination of products and services?
			H. Does the entity file Form 1099s for payments to individuals, partnerships, and certain corporations?
			I. Does the entity file Form 1099s for payments to attorneys, even if incorporated?
			J. Does the entity file Form 1099s for certain medical and health care payments, even if incorporated?

Yes	No	N/A	
			K. Did the organization receive CP2100 Notice (backup withholding) for prior years information returns that contained missing, incorrect, and /or currently not issued taxpayer identification numbers?
			L. Did the entity make payments of \$10 or more for royalties?
			3. <u>International Issues:</u>
			A. Does the entity have control or signatory authority over any foreign bank accounts?
			B. Does the entity have employees working overseas?
			C. Does the entity conduct trade or business overseas?
			4. <u>Policies:</u>
			A. Does the entity have a cell phone policy?
			B. Does the entity have a travel reimbursement policy?
			C. Does the agency comply with the accountable plan rules?
			D. Do you offer reimbursement for educational attainment to your employees?
			E. Does the entity have a spousal expense policy?
			5. <u>Are you required to file any of the following federal tax returns?</u>
			A. Form 941, Employers Quarterly Federal Tax Return
			B. Form 945, Annual Return of Withheld Federal Income Tax
			C. Form 990, Return of Exempt Organization
			D. Form 990T, Exempt Organization Business Income Tax Return
			E. Form 720, Quarterly Excise Tax Return
			F. Form 1042, Annual Withholding Return for U.S. Source Income of Foreign Persons
			G. Form 1042SS, U.S. Self-Employment Tax Return
			H. Form 1096, Annual Summary and Transmittal of U.S. Information Returns
			I. Form 1098E, Student Loan Interest Statement
			J. Form 1098T, Tuition Statement

Yes	No	N/A	
			K. Form 1099 M, Statement for Recipients of Miscellaneous Income
			L. Form 1099 R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. and IRA Contribution Information
			M. Form 8300, Cash Transactions over \$10,000 received in trade or business
			N. Form W-2, Wage and Tax Statement
			O. Form W-3, Transmittal of Wage and Tax Statements
			6. Forms W-4, Employee's Withholding Allowance Certificate
			A. Are Forms W-4 on file for every employee?
			B. Are all forms W-4 secured prior to initial payment?
			C. Are all forms W-4 properly completed?
			D. Are new forms W-4 secured each year on all individuals claiming to be exempt from income tax withholding?
			7. Forms W-5, Earned Income Credit Advance Payment Certificate
			<p>8. Do you make any payments for which you do not have a correct Taxpayer Identification Number (TIN)?</p> <p>Note: Special requirements apply to backup withholding requirements for government entities. When <i>workers are independent contractors</i>, the governmental entity may have information- reporting and backup withholding responsibilities, but is not required to withhold and pay employment taxes on behalf of the worker.</p> <p>Government entities that make certain payments are required to withhold income tax of 28% from these payments if the payee is not exempt from backup withholding and fails to furnish correct taxpayer identification number (TIN). Backup withholding does not apply to wages or pension payments.</p> <p>For further information about backup withholding, see Publication 963: http://www.irs.gov/pub/irs-pdf/p963.pdf. Also, a more detailed compliance checklist for IRS backup withholding requirements is available at: (INSERT LINK BEFORE PILOT TESTING FORM)</p>

Social Security Benefits Offsets for Public Employees

Note: The IRS has no jurisdiction over Social Security offset provisions discussed in this section. This section is included in the Checklist to ensure public employers know those compliance requirements, even though they are not tax issues. All questions related to this section of the Checklist should be addressed to the U.S. Social Security Administration.

*Some Federal employees and employees of State or local government agencies may be eligible for pensions that are based on earnings **not** covered by Social Security.*

*If you have employees who did not pay Social Security taxes on their government earnings **and** they are eligible for Social Security benefits, the formula used to figure the employee's Social Security benefit amount may be modified, giving the employee a lower Social Security benefit. Go to the Social Security Administration's website for details: <http://www.ssa.gov/gpo-wep/>. There are two types of pension offsets: Windfall Elimination Provision (WEP) and Government Pension Offset (GPO).*

1. *If an employee is eligible for Social Security benefits on his/her own record: The [Windfall Elimination Provision](#) (WEP) fact sheet explain [the formula Social Security may use to modify your benefit amount](#). The WEP fact sheet is at: <http://www.ssa.gov/pubs/10045.html>.*
2. *If an employee is eligible for Social Security benefits on his/her spouse's record: The [Government Pension Offset](#) (GPO) fact sheet explains [how an employee's pension may affect his/her benefit on his/her spouse's record](#). The GPO fact sheet is at: <http://www.ssa.gov/pubs/10007.html>*

Note: *Some government pensions do not affect an employee's benefit on his/her spouse's record. For details, go to SSA's website at: <http://www.ssa.gov/pubs/10007.html#when>.*

Section 419(c) of Public Law 108-203, the Social Security Protection Act of 2004, requires State and local government employers to provide a statement to employees hired January 1, 2005, or later in a job not covered under Social Security. The statement explains how a pension from that job could affect future Social Security benefits to which they may become entitled. **Form SSA-1945, Statement Concerning Your Employment in a Job Not Covered by Social Security**, available on SSA's website at: <http://www.socialsecurity.gov/form1945/SSA-1945.pdf>, is the document that employers should use to meet the requirements of the law.

Employers must:

- Give the statement to the employee prior to the start of employment;
- Get the employee's signature on the form; and
- Submit a copy of the signed form to the pension paying agency.

Yes	No	N/A	
			1. Are you aware that some Federal employees and employees of State or local governments who are eligible for pension that are based on earnings not covered by Social Security and who are eligible for Social Security benefits may have their Social Security benefits modified?
			2. Are you aware that Federal law requires State and local government employers to provide a statement to employees hired on or after January 1, 2005, in a job not covered under Social Security?

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Appendix C

Retirement Plans for Government Employers

The *Retirement Plans for Government Employers* is for informational and reference purposes only. Under no circumstances should the content be used or cited as authority for assuming, or attempting to sustain, a technical position with respect to Federal tax matters. The Internal Revenue Code (IRC), Social Security Act (Act) and related regulations, rulings and case law are the only valid citations of authority for technical matters.

Retirement plans established for the benefit of governmental employees generally function in ways similar to those covering private employers. However, in many cases, different sections of the Internal Revenue Code determine the tax treatment of these plans. Depending on the statutory basis for the plan and how it operates, employer and employee contributions may be subject to Federal income tax at the time of contribution, or tax-deferred until distributed; and they may be taxable or excluded from social security and Medicare taxes (FICA).

Public Retirement Systems (FICA Replacement Plans)

Effective July 2, 1991, Congress made social security coverage mandatory for state and local government employees who are neither covered by a Section 218 Agreement nor qualifying participants in a public retirement system. Under this provision, states can provide these mandatorily covered employees with membership in a public retirement system as an alternative to mandatory social security coverage. Employees may also be covered by both a public retirement system and social security under a section 218 Agreement.

A governmental retirement plan must meet certain minimum benefit or contribution standards to qualify as a public retirement system, and thereby serve as a “replacement” plan exempting the participants from mandatory social security coverage. These standards are based solely on meeting a minimum benefit level provided (defined benefit plan), or a minimum amount contributed (defined contribution plan) to the participant. Whether a plan meets the standard to exempt employees from mandatory FICA has no bearing on the rules discussed below, and a public retirement system is not necessarily a “qualified plan” within the meaning of Employee Retirement Income Security Act (ERISA). For a detailed discussion of the requirements for public retirement systems, see Chapter 6 of [Publication 963](#), Federal-State Reference Guide.

Types of Public Employer Plans

The following types of retirement plans are discussed here (sections refer to the Internal Revenue Code)

- Section 401(a) - Qualified Plan
- Section 403(b) – Annuity for public schools and 501(c)(3) organizations
- Section 457(b) – Nonqualified, eligible deferred compensation plans for state and local governments and tax-exempt organizations
- Section 457(f) – Nonqualified, ineligible deferred compensation plans

Note: After May 6, 1986, state and local governments are not eligible to adopt Section 401(k) plans except for rural cooperatives, Indian tribal entities. Under grandfather provisions, plans established prior to that date may continue to operate and add new participants.

Almost all governmental plans are covered under one of these sections. They are discussed individually below.

Key Terms and Concepts

The following are some important terms that are used in discussing the features of public employer plans.

Constructive Receipt: Under the provisions of sections 451 and 457 of the Internal Revenue Code, generally all amounts employees receive are taxable when received or made available to the employee. However, numerous code sections provide exceptions to either defer or exempt amounts from current employee income. They are discussed below as they apply to governmental plans.

Employer Contributions: Amounts credited to individual employee retirement accounts paid in addition to salary; the employee does not have the option to receive these amounts in cash. These amounts are always tax deferred, because the employee does not have constructive receipt. Except for section 457(b) deferrals and section 457(f) contributions, employer contributions are exempt from FICA.

Tax-Deferred: Refers to amounts set aside or credited to the employee retirement account are not included in gross income at the time of the transaction. They are included in income when they are distributed to or constructively received by the employee. Generally, they are subject to withholding requirements at that time also.

Salary Reduction Agreement: An arrangement that provides for amounts recognized as a cash or deferred election because the employee either (a) elects to reduce cash compensation, or (b) elects to forego an increase in cash compensation.

Mandatory Employee Contributions: Amounts deducted from employee salary and credited to a retirement account.

Employer “Pick-Up” Contributions: Section 414(h)(2) allows state or local government entities with section 401(a) plans to treat certain contributions designated as employee contributions, but which are “picked up” (paid) by the employer, to be treated as employer contributions, and therefore as exempt from income tax. This does not include contributions made under a salary reduction agreement. For purposes of FICA, the term “salary reduction” relates to amounts treated as an employer contribution under Code §414(h)(2) that would have been included in wages for FICA tax purposes, but for the employer contribution.

For more information on the requirements to treat contributions as employer pick-ups, see the article in the [January 2007 FSLG Newsletter](#). For more information on pick-up contributions and FICA, see the article in the [July 2007 FSLG Newsletter](#).

Section 401(a) Qualified Plans

Generally, any public employer may set up a 401(a) plan. Under this plan:

Employer contributions not made pursuant to a salary reduction agreement, but including employer “pick-up” contributions, are deferred from income tax until distribution, and exempt social security and Medicare tax.

Employer contributions made under a salary reduction agreement are deferred from income tax, but are subject to FICA tax.

Employee contributions pursuant to a salary reduction agreement are subject to income tax and FICA.

Section 403(b) Plans

Plans under IRC section 403(b), also called tax-sheltered annuities, are available to certain employees of public schools, employees of certain tax-exempt organizations, and certain ministers. To maintain a section 403(b) plan, a governmental employer must be a public school of a state, political subdivision of a state, or an agency or instrumentality of one or more of these. Many public school employees are covered by 403(b) plans in addition to social security coverage under section 218.

403(b) plans resemble “qualified” (i.e., 401(k)) plans in many respects. Eligible participants may defer amounts from income tax up to an annual limit (\$16,500 in 2009). This amount may be increased for certain employees with more than 15 years service. In addition, additional tax-deferred “catch-up” contributions may be made to employees age 50 or older.

Employer contributions (within dollar limitations) are tax-deferred and exempt from FICA.

Employee elective contributions that are considered employer contributions pursuant to a salary reduction agreement are deferred from income tax, but taxable for FICA.

For more information on catch-up contributions to 403(b) plans, see [Publication 571](#).

Section 457(b) Plans

Section 457 addresses nonqualified plans. Many public employees participate in nonqualified, or section 457, plans. These plans can be established by state and local governments or tax-exempt organizations. If they meet the requirements of IRC section 457(b), they are considered “eligible” plans; if not they are considered “ineligible” and are governed by IRC section 457(f).

Governmental 457(b) plans must be funded, with assets held in trust for the benefit of employees. Plan assets and income of all other eligible plans must remain the property of the employer.

Plans eligible under 457(b) may defer amounts from income tax up to an annual limit (\$16,500 in 2009). In addition, “catch-up” contributions may be made to employees age 50 or older (\$5,500 for 2009). Social security and Medicare taxes generally apply to all employer and employee contributions. For further information regarding social security and Medicare tax withholding and reporting on amounts deferred into eligible deferred compensation plans, see [Notice 2003-20](#) and the [irs.gov Employee Plans site](#).

Employer contributions are tax deferred up to annual limits. They are subject to FICA when no longer subject to substantial risk of forfeiture.

Substantial risk of forfeiture. The rights of a person to compensation are subject to substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

Section 1.83-3(c)(1) of the regulations provides that whether a risk of forfeiture is substantial or not depends upon the facts and circumstances

“A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.”

Section 1.83-3(c)(2) of the regulations point out that requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture.

Employee elective contributions are deferred from income tax. They are subject to FICA. However, see [IRS Notice 2003-20](#), VI B, “Timing of social security and Medicare taxes.”

Section 457(f) Plans

Nonqualified state or local government plans that do not meet the tests of 457(b) are ineligible, or 457(f), plans. There is no limit on the annual deferrals on these plans, but to defer taxation all amounts must be subject to substantial risk of forfeiture (see above).. Distributions are generally subject to social security and Medicare taxes at the later of the time 1) when the services giving rise to the related compensation are performed, or 2) when there is no substantial risk of forfeiture of the rights to the amounts.

Employer contributions are includible in income in the year they are no longer subject to any substantial risk of forfeiture. They are subject to income tax withholding in the year they are actually or constructively paid.

Note: IRC §457(f)(1)(A) requires that the contributions be included in the gross income of the participant in the first taxable year in which there is no substantial risk of forfeiture, whereas, IRC §3402(a)(1) requires withholding of federal income tax when the contributions are actually or constructively paid. Thus, while the contributions must be reported as income taxable wages on Form W-2 in the first year in which there is no substantial risk of forfeiture, there may be no income tax withholding requirement at that time. Contributions to funded plans (not meeting the requirements of §457(b)) are constructively paid in the “taxable year in which amounts attributable to employer contribution amounts first become nonforfeitable.”

IRC 457(e)(11)(A)(i) provides exceptions to the above treatment may apply to plans involving bona fide vacation, sick leave, involuntary severance pay, disability or death benefits. For information on the treatment of severance pay plans, see Notice 2007-62. Other regulatory provisions under 457 provide exceptions for:

IRC 457 and Regulation 1.457-2 provide exceptions for certain other cases. Refer to these for further information.

457(f) contributions are subject to FICA at the later of:

When the services are performed, or

When there is no substantial risk of forfeiture and when the amounts are reasonably ascertainable.

Form W-2 Reporting

- Box 1: Income taxable contributions.
- Box 12: Elective salary reduction deferrals to §§401(k), 403(b), 408(k)(6), 408(p); elective deferrals and employer contributions (including nonelective deferrals) to §457(b) unless subject to substantial risk of forfeiture.
- Box 14: Employer may enter the following: (a) nonelective employer contributions made on behalf of an employee, (b) voluntary after-tax contributions that are deducted from an employee's pay, (c) required employee contributions, and (d) employer matching contributions.

Resources for Further Information

[Publication 963](#), Federal-State Reference Guide
[Publication 571](#), Tax-Sheltered Annuity Plans (403(b) Plans)
[Instructions for Forms W-2 and W-3](#)

You may also want to visit the following web pages of the IRS Employee Plans website:

[IRC 403\(b\) Deferred Compensation Plans](#)
[IRC 457\(b\) Deferred Compensation Plans](#)

ⁱ FSLG's compliance program relies on two types of cases: compliance checks and examinations.

There is no statutory or common law definition of the term "examination." However, an examination may be described as the systematic inspection of the books and records of a taxpayer for the purpose of making a determination of the correct tax liability.

A compliance check is a contact with the customer that involves a review of filed information and tax returns of the entity. It is a verification of recordkeeping and tax return and information return filing; it is not directly related to the determination of a tax liability. It is not an examination or audit.

A compliance check is different from an examination because:

- Books and records are not inspected, and
- There is no attempt to determine tax liability.

A compliance check is an alternative to an examination. It is less burdensome to the taxpayer and can generally be accomplished in one or two contacts with the taxpayer. It serves as an opportunity to educate the taxpayer and encourage compliance with regard to employment tax law and filing requirements.

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